89-1832

No. .....

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

HEALTHCARE INTERNATIONAL, INC., WEST OAKS, INC., HEALTHCARE-BROWN MANAGEMENT CO., THE BROWN SCHOOLS, INC., JAMES L. FARISS, JR., DAVID L. WHELAN, AND ELLIOTT H. WEIR, JR.,
Petitioners,

v.

L & B HOSPITAL VENTURES, INC., LEO J. BORRELL, BOBBY R. LOWRANCE, PSYCHIATRIC ASSOCIATES OF HOUSTON, P.A., AND DOUGLAS B. HANSEN,
Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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QUESTIONS PRESENTED

1. Whether an investor who has significant input into the day-to-day operations of a partnership may claim that his or her interest is an "investment contract" under the test set forth in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), which requires that the investor have an expectation of profits derived "solely from the efforts of the promotor."

2. Whether an investor who makes an undeniably significant contribution to the profitability and success of a partnership may claim that his partnership interest is an "investment contract."

3. Whether an investor in a partnership who, in economic reality, makes an undeniably significant contribution to the profit or loss of the partnership, is the owner of a "security" simply because the partnership agreement is labelled a "limited partnership agreement" and purports to limit the investor's control over the management of the partnership.

4. Whether the originator, developer and seller of an investment who retains an interest in the venture thereafter has a "security."

5. Under *Celotex Corp. v. Catrett*, 477 U.S. 317 (1986), may a party with the burden to prove his or her partnership interest is a "security" avoid summary judgment where the summary judgment evidence regarding his or her substantial involvement in the partnership's business is not disputed?

RULE 28.1 LIST

Pursuant to Supreme Court Rule 28.1(b), the following is a list of all parties to the proceedings below:

1. L&B Hospital Ventures, Inc., Plaintiff.
2. Leo J. Borrell, Plaintiff.
3. Bobby R. Lowrance, Plaintiff.
4. Psychiatric Associates of Houston, P.A., Plaintiff.
5. Douglas B. Hansen, Plaintiff.
6. Healthcare International, Inc., Defendant.
7. West Oaks, Inc., Defendant.
8. Healthcare-Brown Management Co., Defendant.
9. The Brown Schools, Inc., Defendant.
10. James L. Fariss, Jr., Defendant.
11. David L. Whelan, Defendant.
12. Elliott H. Weir, Jr., Defendant.
13. William H. Boylston, Third-Party Defendant.
14. Jules H. Bohn, Third-Party Defendant.
15. Peter A. Olsson, Third-Party Defendant.
16. Ramesh R. Parikh, Third-Party Defendant.
17. V. Thomas Lankford, Jr. and Paul V. Castellitto, of the firm of Sharp, Green & Lankford, attorneys for Plaintiffs.
18. Philip P. Sudan, Jr., of the firm of Ryan, Shoss, Sudan & Lawley, attorneys for Plaintiffs.
19. Robin C. Gibbs, Robert N. Brailas, and Jeffrey C. Alexander of the firm of Gibbs & Ratliff, attorneys for Defendants and Third-Party Plaintiffs.

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To the Honorable Chief Justice and the Associate Justices of the Supreme Court of the United States of America:

Petitioners Healthcare International, Inc. ("Healthcare"), West Oaks, Inc., Healthcare-Brown Management Co., The Brown Schools, Inc., James L. Fariss, Jr., David L. Whelan, and Elliott H. Weir, Jr., respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Fifth Circuit.

OPINIONS BELOW

The opinion of the Court of Appeals is reported at 894 F.2d 150, and is reprinted in the appendix attached hereto, p. A1. The opinion of the United States District Court for the Southern District of Texas, Houston Division is not reported and is reprinted in the appendix attached, p. A10.

JURISDICTION

This suit was originally filed asserting claims under section 10 of the Securities Exchange Act of 1934, 15 U.S.C. § 78j and Rule 10b-5 promulgated thereunder, 17 C.F.R. 240.10b-5. On February 2, 1989, the District Court signed an order granting summary judgment against Plaintiffs on their claims under federal securities laws, which was entered of record on February 5, 1989. On February 2, 1989, the District Court entered an order finally disposing of all claims. This order was entered of record on February 6, 1989. On February 12, 1990, a panel of the Fifth Circuit reversed the District Court's judgment, and on March 26, 1990, the Fifth Circuit denied Petitioner's suggestion for rehearing *en banc*. Jurisdiction of this matter is proper pursuant to 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS

15 U.S.C. § 78c. Definitions and application

(a) When used in this chapter, unless the context otherwise requires — . . . .

(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

STATEMENT OF THE CASE

I. Overview

This case raises important issues regarding the scope of the federal securities laws in cases where the investor seeks to assert that his interest in a partnership venture is an "investment contract." In particular, this case raises important and recurring questions as to whether merely labelling an investment a "limited partnership" and purporting to limit the investors' role in formal legal documents renders the investment a "security," subject to the formidable regulatory scheme of the federal securities statutes.

In *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946), this Court held that in order to qualify as an investment contract, a transaction must be one in which a person "invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party . . ." *Id.* at 299. The Fifth Circuit held in this case that the only "*managerial efforts*" need be considered in applying this test. App. at A6; 894 F.2d at 152 (emphasis in original). Thus, despite voluminous and undisputed evidence showing beyond question that the Plaintiffs in this case had substantial input into the venture's operations and were the key factor in the venture's economic success, the Court of Appeals found that a fact issue existed as to the allocation of "managerial" control.

Additionally, this case raises fundamental questions regarding the interplay between the standard for granting summary judgment under Fed. R. Civ. P. 56 and the test for whether a partnership interest is an investment contract. Under *Celotex Corp. v. Catrett*, 477 U.S. 317, 322 (1986), the Plaintiff-Doctors, who have the burden of proving their partnership interests were "securities," were required to raise a fact issue on every element of the *Howey* test. They failed to controvert the specific instances of substantial participation in the venture established by Petitioners in their summary judgment motion. Thus, they failed to raise an issue as to whether they substantially participated in the venture's operations.

II. Factual Background

A. The Doctors Originally Promoted the Venture

The evidence adduced in this case established that Dr. Leo Borrell, Dr. Bobby Lowrance and Dr. Douglas Hansen (the "Plaintiff-Doctors"), along with Dr. Edwards U. McReynolds, a principal in Plaintiff Psychiatric Associates of Houston, P.A. ("PAH"), correctly characterized themselves as the "Founding

Fathers" of the West Oaks Hospital.[1] R. 687, 738-39.[2] Beginning in 1976 or 1977, these four doctors undertook to develop a new hospital, which they intended to own and to which they would admit their patients. R. 716-17, 779, 787-88. Plaintiffs intended to develop and implement their programs at the hospital for treatment of children and adolescents. R. 687-88, 723-26, 779, 831-33. They hired their own business consultant and attorneys, and filed their own certificate of need application for the project as then required by state law. R. 688, 723-26, 741-76, 784, 813, 832-33. They personally invested some $120,000 in promotional expenses for the project before Petitioners entered the picture. R. 739. The original plans for the hospital were initiated in the period 1976 through June 1979, prior to any involvement by Petitioners. R. 687, 713-15, 787-88, 812-20, 831-33.

Plaintiffs (sometimes referred to as "the Doctors") then negotiated with several national healthcare companies to provide administrative and financial support. R. 688, 721-22, 779-80, 814-16, 833-35. In mid-1979, when negotiations with other companies broke down, the Doctors approached The Brown Schools, Inc. ("Brown Schools"), later a subsidiary of Petitioner Healthcare International, Inc. to join in the hospital venture. On June 19, 1979, an agreement was reached whereby the doctors retained a 25% ownership interest in the hospital project and conveyed a 75% interest to Brown Schools under a limited partnership arrangement. Brown Schools was to hold its 75% interest as a general partner and Lowrance, Borrell, Hansen and

---

[1] The only other Plaintiff, L&B Hospital Ventures, Inc., is a corporate entity owned by Lowrance and Borrell.

[2] Because this case involves the application of summary judgment standards to the evidence in this case, Petitioners respectfully recommend certification of the record to the Court. Sup. Ct. Rule 19.1. References to the record shall be by page number in the record transmitted to the Court of Appeals. For example, page 600 of the Record shall be cited as "R. 600."

PAH would hold equal "limited partnership" shares of 6.25% each. R. 689, 731-32, 819-21, 822-24, 838-39. Brown Schools was to provide administrative services to the hospital and arrange financing for construction and operation of the hospital. R. 689, 779-81, 836, 929-30. However, the letter of intent signed by the parties expressly provided that "[the Doctors] shall have the right to review and approve the hiring of the medical director, and an appropriate joint committee will be formed with the Doctors as members for discussion of mutual concerns." R. 823.

When the Doctors decided to terminate their relationship with Healthcare, they negotiated to purchase Healthcare's 75% interest. R. 803-04, 867-68, 73-75. Failing in that effort, they sold their interests to Healthcare and used the proceeds to construct a competing hospital. R. 803-04, 867-68, 805-09, 852-60. They subsequently brought this suit, asserting that in purchasing their limited partnership interests Healthcare had concealed material information regarding the value of the hospital. Healthcare counterclaimed, alleging that the Doctors had failed to reveal their plans to open a competing facility. After substantial discovery, the District Court held that the Doctors' substantial participation in and control over the success of the hospital precluded their securities claims as a matter of law. Healthcare's claims against the Doctors and the Doctors' state-law claims against Healthcare are the subject of a pending action in Texas state court.

B. The Doctors Had Significant Input into and Control of the Hospital's Daily Operations

The summary judgment evidence submitted to the trial court established as a matter of law that the Plaintiff-Doctors had substantial input into the daily operations of the hospital. Most of that evidence consisted of the Doctors' own sworn deposition testimony regarding the importance of their contributions to the continued operation and success of the venture. For example,

Plaintiffs confirmed in their depositions their active participation in hospital staff education, program design and development, physical structural design, personnel evaluation, transfer and admission of patients, sharing of patients and third-party insurance information. R. 729-30, 788, 794-97, 842, 932-33, 936-38, 940. Dr. Lowrance described their ongoing involvement in the affairs of the hospital as follows:

> Q: And would you tell us the ways in which you and the rest of the limited partner doctors involved yourself in the ongoing operations of the Hospital after it opened?
>
> A: Establishing a medical staff and the allied health professional staff, the setting up of medical staff committees. We chaired most of those committees. We were active in the Medical Staff Executive Committee, and had an active role in the recruitment of physicians to practice at the hospital and allied health professionals, and assisted the hospital in developing an excellent reputation for high quality medical staff and allied health professional staff and high quality patient care. We developed the children's program and employed child psychiatrists to run that program. We actively participated with the hospital in continuing education and development of an ongoing continuing education program both for the general public as well as for the professional community, both within and outside the hospital. We also worked with the hospital around issues about marketing of the hospital and the hospital programs.

R. 843-44.

The Doctors also entered into a number of contracts with the hospital under which they rendered vital operational services to the venture. They provided a host of services under a "Clinical Advisory Agreement," which Dr. McReynolds testified was "seen probably as the seat of power in the hospital." R. 729-90, 840, 907-26, 932-34, 940, 947-48. The Doctors formed Psychiatric Hospital Consultants of Houston, Inc. to be the "Advisor" under

the Clinical Advisory Agreement. The Agreement expressly provided that the hospital would not:

> (i) institute, terminate or change in any material respect any Hospital clinical program, or (ii) terminate or change in any material respect the authority or duties of the Medical Director, as set forth in Attachment I, except in good faith and unless Hospital gives Advisor 90 days' prior written notice thereof and affords Advisor a reasonable opportunity to discuss any such institution, termination or change with the General Partner or its designated governing body of the Hospital.

R. 909. By virtue of their service on the Clinical Advisory Committee and Credentials Committee, the Doctors were empowered to (1) hire and fire the medical director, and (2) control whether other doctors and health professionals practiced at the hospital. R. 947-48.

The Doctors also provided services under the Children's Programs Clinical Agreement, R. 840-41, 917-25, and further served as unit medical directors for certain hospital units. Dr. McReynolds described the authority and responsibilities of the unit medical directors as follows:

> Essentially *captain of the ship.* We were responsible for delivery of care. We had administrative assistants who took care of the nuts and bolts, attendance and interviewing. But all the staff direction and staff supervision, staff education, we were the cheerleaders of the unit and clinical directors.

R. 932 (emphasis added). In this capacity, Plaintiffs provided staff direction, supervision and education and shared with Healthcare representatives responsibility for hiring and firing of staff. R. 932-33, 947.

Dr. Hansen served as Medical Director of the hospital and in that capacity was responsible for overseeing the medical and clinical aspects of the hospital, including directing and coordinating all psychiatric and medical activities, supervising the medical

staff, developing organizational plans, advising the hospital administrator with regard to problem employees and on questions of policy, advising the medical staff on medical and administrative problems, and numerous other responsibilities. R. 796, 946-47, 949-60. At the inception of the partnership, Dr. Hansen signed a five-year agreement to serve as manager of the children's program at the hospital. R. 917, 925. The agreement required the hospital to cooperate with the manager, R. 920, and authorized the manager to provide or cause to be provided physician and professional services necessary to operate the children's program. R. 918.

As unit medical directors, the Doctors sat on the hospital's executive committee and participated in review and approval of all clinical business of the hospital. Similarly, they often chaired the Hospital Credentials Committee and the Continuing Education Committee. R. 933-38. Dr. Borrell testified that Plaintiffs had substantial responsibility for promoting the venture to the general public and in recruiting new doctors to practice at the hospital. R. 794-95.

In addition to Plaintiffs' own testimony, Petitioner submitted the Affidavit of Kay Peck, R. 946-60, which stated that:

1. The Medical Director of West Oaks (Dr. Hansen) had considerable power over the daily operations of the hospital (citing 15 specific examples of control);

2. The Doctors served as unit medical directors, giving them powers akin to that of the Medical Director within their specified programs;

3. Under the Clinical Advisory Agreement, the Doctors had substantial input into and control over the development and termination of the hospital's clinical programs, which controlled literally every patient bed in the hospital; and

4. The Doctors controlled the "credentialing" of doctors and thus controlled who could admit patients to the hospital.

No affidavit or other evidence was adduced by Plaintiffs to contradict or deny these statements. Plaintiffs instead labelled their indisputably critical contributions "clinical" and asserted they were outside the scope of the *Howey* test. They also argued that because some of the formal legal documents signed at the inception of the partnership labelled their interests "limited partnership" interests and contained boilerplate language purporting to limit their authority, their interests were securities regardless of the degree of control they actually possessed.

C. The Doctors Made Undeniably Significant Contributions to the Venture's Success

The undisputed summary judgment evidence shows that the Doctors' contributions were vital to the hospital's success. As the trial court found, and as the Doctors themselves admitted, a hospital is "doctor driven." App. at A14; R. 728. The summary judgment evidence was again based largely on Plaintiffs' admissions.

For example, Dr. McReynolds testified that the Doctors admitted 75% to 90% of the hospital's patients during the early years of the hospital, and contributed 50% to 65% of the patients thereafter. R. 931. He agreed that "most of the revenues that were generated up through the end of 1985 for the hospital came from the partner-doctor referrals." R. 941. He expressed the following view of the Doctors' contributions to the hospital enterprise:

> Q: Would you agree that the partner-doctors, over the years prior to the sale of their partnership interest, *both in terms of their contribution to revenue and in the contribution to management of the operations of the hospital, contributed substantially to the profitability of the hospital?*
>
> A: Certainly.

R. 937-38 (emphasis added).

Dr. Lowrance similarly testified in deposition that Plaintiffs *definitely* "contributed very substantially to the profitability which this hospital experienced once it opened its doors." R. 845. Dr. Borrell testified that at first the Plaintiff-Doctors contributed 70% to 80% of the admissions and later, after hospital expansion, 40% to 70% of the hospital's patients. R. 789-90. He enumerated the Doctors' contributions to the "success," "substantial value" and "profitability of the partnership" in his deposition. R. 791-95. In his deposition, Dr. Borrell agreed that the "profitability or failure of the venture . . . was in large part relying on you Doctors' performance. . . ." R. 800-01.

Finally, Dr. Hansen testified that the Doctors were "substantial contributors to the admissions of patients . . . and therefore were a substantial contributor to the profitability of the hospital." R. 740. Dr. Hansen testified that the Plaintiffs were "very important" to the operation, success and profitability of the hospital. R. 729.

The importance of patient admissions to the success of any hospital cannot be overstated. As Dr. Hansen put it, "obviously, any hospital rises or falls on doctors. If they don't have any patients to admit . . . then the hospital fails." R. 728. He later compared the Doctors' influence to that of a "rainmaker" at a law firm:

Q. Tell us how your influence over hospital admissions would give you leverage with Healthcare.

A. Well, it's like your law firm: If one of the partners is bringing in a great number of — a substantial proportion of your business, you tend to listen to what he has to say.

Q. That's because the lifeblood of a hospital was the admission of the patients, in terms of revenues?

A. The lifeblood of a hospital is admissions, any hospital.

R. 733-34.

REASONS FOR GRANTING THE WRIT

I. The Court of Appeals' Decision Conflicts with This Court's Prior Decisions

1. The "Managerial Efforts" Test Adopted by the Court of Appeals Conflicts with This Court's Prior Decisions

This case involves the application of federal securities statutes to the partnership interests retained by the Plaintiff-Doctors when they sold Healthcare International a 75% general partnership interest in a Houston-area hospital. It was undisputed, both in the trial court and in the Court of Appeals, that the partnership interests could be considered "securities" only if they were "investment contracts." 15 U.S.C. § 78c(a)(10) (defining "security" for purposes of the Securities Exchange Act of 1934).

The Supreme Court first defined the term "investment contract" in the seminal case *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). In that case, the Court held:

> [A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.

Id. at 298-99. The Court thus established three elements that must exist before an interest in a business venture may properly be characterized a "security": (1) an investment of money; (2) in a common enterprise; (3) with an expectation of profits derived solely from the efforts of others. If any one of these elements is absent there is no "security" under federal securities laws. *E.g., United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975) (where investor failed to show expectation of profits, no security existed).

The third prong of *Howey* has spawned much litigation since this Court first penned it. It has been widely perceived that the

Court did not intend the language to be applied literally. Thus, the Ninth and Fifth Circuits adopted a more expansive test:

> Strict interpretation of the requirement that profits be earned "solely" from the efforts of others has been subject to criticism. . . . [W]e adopt a more realistic test, whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.

SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973); *see also, SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974) (adopting rule of *Glenn W. Turner Enterprises*). This Court has reserved opinion on the validity of this interpretation of *Howey*. *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 852 n.16 (1975); *see also Villenueve v. Advanced Business Concepts Corp.*, 698 F.2d 1121, 1124-25 (11th Cir. 1983), *aff'd en banc per curiam*, 730 F.2d 1403 (1984) (noting potential for conflict between *Koscot* and *Howey* and reserving question.)

In this case the Fifth Circuit has fundamentally altered the nature of the *Howey* test even beyond the liberal interpretation adopted by the Ninth Circuit. Despite overwhelming and undisputed evidence that the Plaintiff-Doctors had substantial day-to-day participation in and control over the hospital's operations, the Court of Appeals held that those efforts were irrelevant because they were not "managerial." App. at A5, A6. The Court of Appeals did not explain what constitutes "managerial" efforts, nor did it explain in what sense the Doctors' efforts did not meet this test. The test adopted is an unprecedented expansion of the definition of an "investment contract," and conflicts with this Court's admonition that the federal securities acts "[do] not . . . provide a broad federal remedy for all fraud." *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982).

This Court may not have intended for the third prong of the *Howey* test to be applied literally. Petitioners believe, however, that the Court intended in *Howey* to exclude from the ambit of the securities laws situations where, as here, an investor is actively involved in the day-to-day operations of a venture and substantially contributes to its success and profitability. *E.g., Maritan v. Birmingham Properties*, 875 F.2d 1451 (10th Cir. 1989); *Villenueve v. Advanced Business Concepts Corp.*, 698 F.2d 1121, 1124-25 (11th Cir. 1983), *aff'd en banc per curiam*, 730 F.2d 1403 (1984); *Gordon v. Terry*, 684 F.2d 736 (11th Cir. 1982), *cert. denied*, 459 U.S. 1203 (1983); *Frazier v. Manson*, 651 F.2d 1078 (5th Cir. 1981); *Martin v. T.V. Tempo, Inc.*, 628 F.2d 887 (5th Cir. 1980); *Crowley v. Montgomery Ward & Co.*, 570 F.2d 877, 880-81 (10th Cir. 1978); *Slevin v. Pedersen Associates, Inc.*, 540 F. Supp. 437 (S.D.N.Y. 1982). The Plaintiff-Doctors cited no case — and Healthcare is aware of none — where the founder, promoter and key "rainmaker" of a partnership successfully asserted that his or her interest in the partnership was a "security." The Court of Appeals' decision alters this *Howey* principle, holding that so long as a party may label his or her contributions as something other than "managerial" efforts, those efforts cannot be considered in applying *Howey* regardless of how important they were to the success of the enterprise.[3]

Furthermore, the Court of Appeals relied heavily on the fact that the Doctors' interests were called "limited partnership"

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[3] The distinction between "managerial" and "clinical" efforts is far from clear. The entire business of a hospital is the provision of clinical services to patients. The Plaintiff-Doctors were by their own admission involved in staff decisions, resource allocation, purchasing and other ostensibly "managerial" functions. If the Fifth Circuit's "managerial" versus "clinical" distinction is upheld, one can foresee a multitude of other distinctions being offered, as investors claim their contributions were "operational," "supervisory," "advisory," "promotional," or any one of hundreds of other labels clever attorneys can dream up to avoid the clear dictates of *Howey* that substantial participation in the enterprise takes the interest outside the federal securities laws.

interests and on formal recitations in the partnership agreement. App. at A6-A7. In doing so, the Court of Appeals strayed from the fundamental principle that in applying the *Howey* test, "form should be disregarded for substance and the emphasis should be on economic reality." *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967). Thus, regardless of the label placed on the interest, it is not an "investment contract" unless it meets the *Howey* test. *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975). It has been recognized by other federal courts that limited partnership interests are not inherently "securities." *See, e.g., Gordon v. Terry*, 684 F.2d 736, 741 n.5 (11th Cir. 1982), *cert. denied*, 459 U.S. 1203 (1983); *Frazier v. Manson*, 651 F.2d 1078 (5th Cir. 1981); *Bailey v. J.W.K. Properties, Inc.*, 703 F. Supp. 478 (W.D. Va. 1989); *Bamco 18 v. Reeves*, 675 F. Supp. 826 (S.D.N.Y. 1987); *Bank of America National Trust & Savings Ass'n v. Hotel Rittenhouse Assocs.*, 595 F. Supp. 800 (E.D. Pa. 1984).

As Professor Loss has noted:

> Interests in partnerships may be securities. . . . The problem, as Judge Frank put it when he was Chairman of the SEC, is to distinguish between the public offering of securities parading as "limited partnership interests" and "an offering of a half-interest in a hamburger stand."

Loss, *Fundamentals of Securities Regulation*, 198-99 (1983).

The factors used by courts in determining whether a limited partnership interest is a security all suggest that the interests involved in this case are not. For example, there were only four limited partners. *Cf. Bamco 18*, 675 F. Supp. at 830 (stressing that a limited partnership with few limited partners is generally not a security); *Bank of America National Trust & Savings Ass'n*, 595 F. Supp. at 806-07 (E.D. Pa. 1984). Furthermore, the agreements in this case have the unique qualities arising from the "one-on-one negotiations" that generally take commercial con-

tracts out of the securities laws. *Marine Bank v. Weaver*, 455 U.S. 551, 559-60 (1982) ("We hold that this unique agreement negotiated one-on-one by the parties is not a security."); *Bank of America National Trust & Savings Ass'n*, 595 F. Supp. at 806-07. Additionally, where, as here, the limited partners have collateral contractual relationships with the venture that give an added measure of control, such authority takes their interest outside the scope of *Howey*. *Frazier v. Manson*, 651 F.2d 1078 (5th Cir. 1981).

2. The Promoter of a Venture Cannot Assert That His or Her Interest Is a "Security"

In *Howey*, the Supreme Court stated that a security exists only when one is induced to invest money on the promise that profits will come from the efforts of the promoter. This test clearly contemplates that the promoter himself cannot assert that his or her interest is a security, because the promoter cannot claim that he or she was "induced" into the venture by the promises of others.[4]

This Court recently examined the scope of federal securities statutes in *Reves v. Ernst & Young*, 58 U.S.L.W. 4208 (1990). The Court recognized that the key to determining whether the securities laws apply to an investment is the nature and purpose of the transaction. Recognizing the limited scope of the securities

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[4] Of course, as the Supreme Court has noted, the *Howey* analysis does not apply to more traditional investments, such as stocks and bonds, expressly listed as securities in the Act. *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985). Rather, the test applies to determine whether instruments not specifically enumerated "securities" may nevertheless be characterized as such because they serve as a de facto substitute for traditional securities.

statutes, *id.*, the Court held that whether a note is a "security" depends on the purposes underlying its purchase:

> If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a "security." If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a "security."

Id. The Court intended by this test to limit the scope of the securities laws to those situations where one seeks "the use of the money of others on the promise of profits." *Id.* (quoting *SEC v. W. J. Howey Co.*, 328 U.S. 293, 299 (1946)).

These considerations indicate that the promotor of an enterprise simply cannot claim that his retained interest in an enterprise is an "investment contract." In this case, the Plaintiff-Doctors were not victimized by someone seeking to use their money. Rather, it was the Doctors, after having already spent over $120,000 promoting the venture, who sought to induce Healthcare to part with its money on the promise that the Doctors would ensure a profit by admitting their own patients, inducing other doctors to admit patients, and developing and operating clinical programs that would keep the hospital full. The Doctors' lawsuit turns *Howey* on its head — the "investor" is in this case being sued by the very "promoters" the securities laws were intended to regulate.

3. The Court of Appeals' Decision Is Contrary to the Summary Judgment Principles Set Forth in *Celotex*

It is now established that the party bearing the burden of proof on an issue must come forward with evidence raising a fact question on every essential element of that issue in response to a

summary judgment motion. *Celotex Corp. v. Catrett*, 477 U.S. 317 (1986). Where the party with the burden fails to do so, summary judgment should be granted. *Id.*

In *Celotex*, this Court noted:

> Summary judgment procedure is properly regarded not as a disfavored procedural shortcut, but rather as an integral part of the Federal Rules as a whole, which are designed "to secure the just, speedy and inexpensive resolution of every action." Fed. R. Civ. P. 1. . . . Rule 56 must be construed with due regard not only for the rights of persons asserting claims and defenses that are adequately based in fact . . ., but also for the rights of persons opposing such claims and defenses to demonstrate in the manner provided by the Rule, prior to trial, that the claims and defenses have no factual basis.

Id. at 327. In this case, one "essential element" on which the Plaintiff-Doctors bear the burden of proof is to show that their partnership interests in the hospital were "securities" under the *Howey* test.

This case thus presents an interesting juxtaposition of procedural and substantive rules. On the one hand, Rule 56 requires that the Plaintiff-Doctors raise a fact issue. Fed. R. Civ. P. 56; *Celotex*, 477 U.S. at 322-23. On the other hand, under *Howey*, the Doctors' interests are not securities if the Doctors did not invest money with an expectation of profits derived solely from the efforts of the promoters. *Howey*, 328 U.S. at 299. The burden under *Celotex*, therefore, was for the Plaintiff-Doctors to show that they played no substantial part in the operation or success of the enterprise. *Cf. Albanese v. Florida National Bank*, 823 F.2d 408, 410 (11th Cir. 1987) (per curiam); *Gordon v. Terry*, 684 F.2d 736, 741 (11th Cir. 1982), *cert. denied*, 459 U.S. 1203 (1983); *Frazier v. Manson*, 651 F.2d 1078, 1080 (5th Cir. 1981); *Martin v. T.V. Tempo, Inc.*, 628 F.2d 887, 891 (5th Cir. 1980).[7]

The analysis trial courts must employ under *Celotex* in this situation may be analogized to a measuring cup. The cup bears a line representing the threshold level of participation in and contribution to an enterprise that takes the investment outside the ambit of federal securities statutes. Once the evidence of a plaintiff's contributions exceeds this threshold, the efforts are deemed so substantial that it cannot reasonably be said that the plaintiff expected profits derived solely from the efforts of the promoter. Historically, the federal courts have held that the *Howey* threshold is not crossed if the investors' efforts may be considered to fall below the contribution line designated "menial," "nominal," or "ministerial" — i.e., where the investor's efforts have little practical effect on the profitability or success of the venture.[5] *Fargo Partners v. Dain Corp.*, 540 F.2d 912, 914-15 (8th Cir. 1976). Once this threshold is crossed, however, federal courts recognize that as a matter of law no "security" exists under *Howey*. *Id.*

Where a movant has established facts showing that the plaintiff's efforts exceed the *Howey* threshold, it is not enough for the plaintiff to list other functions he or she did not perform. To

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[5] This threshold is historically a low one. Any substantial contribution by the investor takes the interest outside the scope of the statute. Hence, federal courts have often granted summary judgment in securities cases where the interest fails to meet the *Howey* test. *E.g., Marine Bank v. Weaver*, 455 U.S. 551 (1982); *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, (1975); *Maritan v. Birmingham Properties*, 875 F.2d 1451 (10th Cir. 1989); *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236 (4th Cir. 1988); *Meyer v. Dans un Jardin, S.A.*, 816 F.2d 533 (10th Cir. 1987); *Villenueve v. Advanced Business Concepts Corp.*, 698 F.2d 1121 (11th Cir. 1983), *aff'd en banc per curiam*, 730 F.2d 1403 (1984); *Frazier v. Manson*, 651 F.2d 1078 (5th Cir. 1981); *Crowley v. Montgomery Ward & Co.*, 570 F.2d 877 (10th Cir. 1978); *Fargo Partners v. Dain Corp.*, 540 F.2d 912 (8th Cir. 1976); *Bailey v. J.W.K. Properties, Inc.*, 703 F. Supp. 478 (W.D. Va. 1989); *Bamco 18 v. Reeves*, 675 F. Supp. 826 (S.D.N.Y. 1987); *Inforex Corp. v. MGM/UA Entertainment Co.*, 608 F. Supp. 129 (C.D. Cal. 1984).

continue the analogy, one cannot reduce excess water in the measuring cup by pointing to the remaining space. Whether the cup is "half full" or "half empty", it still contains more than the permitted measure. Similarly, no matter how many functions a plaintiff may claim he or she does not perform for a joint venture, the specific facts taking the plaintiff's efforts across the *Howey* threshold remain.

The plaintiff faced with a properly supported summary judgment motion in this context must instead confront and directly controvert the specific facts adduced by the movant. The focus is on the investor's contributions to the enterprise. Unless the plaintiff can raise a fact issue on the importance of his or her contributions to the venture, the threshold has been passed and summary judgment is appropriate. To return to the analogy, once the measure in the cup passes the "nominal" level, the plaintiff cannot rely on the remaining "empty air" in the cup; instead, he or she must remove some of the water to reduce the level below the threshold.

In this case, Healthcare submitted summary judgment proof detailing the Doctors' very substantial contributions to the venture. This proof was largely composed of the Doctors' own testimony. *See*, pp. 3-10, *supra*. The Doctors did not dispute the facts adduced in Healthcare's motion; rather, they compiled a "laundry list" of functions performed by others. As the district court correctly noted in its opinion, the focus of proof in a case such as this cannot be on what the Plaintiff-Doctors did not do; rather, the issue is whether the functions the Plaintiff-Doctors performed were sufficiently important to the hospital's success to negate the third prong of the *Howey* test. App. at A15; *see also Bailey v. J.W.K. Properties, Inc.*, 703 F. Supp. 478 (W.D. Va. 1989) (movant need not show that plaintiffs controlled "every detail" of venture, but only needed to show "significant" control). Under *Celotex*, the Plaintiff-Doctors' failure to come forward

with evidence negating the specific, documented evidence of the Plaintiffs' input into and control over critical functions and hospital profitability establishes those facts as a matter of law. It was therefore undisputed that the Plaintiff-Doctors:

1. Significantly controlled the "lifeblood" of the venture — patient admissions;

2. Controlled the Credentials Committee, which determined who could admit patients to the hospital and, therefore, who could use the hospital's services;

3. Directed the allocation of the hospital's resources by virtue of the Clinical Advisory Agreement, the Medical Directorship, and the Unit Medical Directorships, because all the beds at the hospital were committed to one or another of the clinical programs controlled by these positions;

4. Had significant control over and input into any material changes in the operations by virtue of the Clinical Advisory Agreement, which required that Appellants receive 90 days' notice of any material change in the hospital's programs; and

5. Had substantial input into and responsibility for recruiting doctors, had supervisory powers over hospital staff, had input into hiring, firing and promotion decisions, and were responsible for promoting the hospital's public image through lectures and appearances.

By no stretch of the English language could these contributions be considered nominal or unimportant. Thus, the Plaintiffs failed to carry their burden under *Howey* to raise a fact issue as to whether they expected profits derived "solely" from the efforts of others, and the trial court properly granted summary judgment.

II. The Court of Appeals' Decision Conflicts with Other Federal Courts' Holdings

1. Other Federal Courts Recognize That an Investor Who Contributes Substantially to the Success of a Partnership May Not Assert Securities Claims

The Court of Appeals held in this case that the essential test for whether a partnership interest may be considered a security is whether the investor's contributions are "managerial." In so holding, it declined to examine the impact the Plaintiff-Doctors' efforts had on the overall success and profitability of the partnership's sole asset, West Oaks Hospital. The Fifth Circuit's failure to undertake that analysis is contrary to the test applied by other federal courts in dealing with this issue.

Under *Howey*, the touchstone of an "investment contract" is an expectation of "*profits* derived solely from the efforts of the promoter. . . ." 328 U.S. at 299 (emphasis added). In applying the *Howey* test, other federal courts have recognized that "an investor who has the ability to control the profitability of his investment, either by his own efforts or by majority vote in group ventures, is not dependent upon the managerial skills of others." *Gordon v. Terry*, 684 F.2d 736, 741 (11th Cir. 1982), *cert. denied*, 459 U.S. 1203 (1983); *see also Albanese v. Florida National Bank*, 823 F.2d 408, 410 (11th Cir. 1987) (per curiam); *Martin v. T.V. Tempo, Inc.*, 628 F.2d 887, 891 (5th Cir. 1980); *Bender v. Continental Towers Limited Partnership*, 632 F. Supp. 497, 501 (S.D.N.Y. 1986). As the *Bender* court noted in applying the *Howey* test:

> "In each case [in which there was a security], without the efforts of the promoters, the investment would be worthless."

Id. at 501.

In *Williamson v. Tucker*, 645 F.2d 404 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981), the Fifth Circuit undertook a thoughtful

analysis of the application of *Howey* to partnership interests, holding:

> [M]eaningful powers possessed by joint venturers under a joint venture agreement do indeed preclude a finding that joint venture interests are securities.

Id. at 425. The court enumerated four specific, limited exceptions to this rule, each predicated on a finding that, despite the potential existence of meaningful powers in the partners, unique facts created a "genuine dependence" by the partners on the expertise of the promoters. *Id.* at 422-23. As the court noted:

> If, for example, the partner has irrevocably delegated his powers, or is incapable of exercising them, or is so dependent upon the particular expertise of the promoter or manager that he has no reasonable alternative to reliance on that person, then his partnership powers may be inadequate to protect him from the dependence on others which is implicit in an investment contract.

Id. at 422-23.

In this case, there is no dispute that the Doctors possessed "meaningful powers" — they admitted their substantial participation in the venture and critical contributions to its success at length in their depositions. Nor can there be any issue regarding "genuine dependence," because the Doctors admitted that they (1) had almost concluded a contract with an alternate management company prior to engaging Healthcare; (2) negotiated to purchase the venture from Healthcare prior to selling their interests; and (3) built and operated a competing hospital after selling their interests. Thus, Healthcare possessed no unique or irreplaceable skills that would negate the Doctors' influence or render them powerless.

The Plaintiff-Doctors were, by their own admission, the "rainmakers" of the venture, and enjoyed the influence and power that go with such a position. Their decisions as clinical directors

were vital to the operation of the venture. So long as the Plaintiff-Doctors admitted their patients and served as directors of the hospital's programs, West Oaks would be a success regardless of who "managed" the venture. When the Doctors removed their patients, the hospital immediately began to suffer. *Cf. Martin v. T.V. Tempo, Inc.*, 628 F.2d 887 (5th Cir. 1980) (franchisee's efforts in locating advertisers were critical to profitability; hence, no security existed). Their own sworn testimony leaves the Doctors no room now to disavow their substantial contribution to the venture's success.

2. Other Federal Courts Have Rejected the "Managerial Efforts" Test Adopted by the Court of Appeals

Parties have attempted before now to distinguish their contributions to a business venture from "managerial" efforts so as to bring their investments within the scope of *Howey*. Given the difficulties inherent in applying such an illusory test, it is not surprising that every other federal court to examine the distinction has rejected it. *See Maritan v. Birmingham Properties*, 875 F.2d 1451 (10th Cir. 1989); *Inforex Corp. v. MGM/UA Entertainment Co.*, 608 F. Supp. 129 (C.D. Cal. 1984); *Slevin v. Pedersen Associates, Inc.*, 540 F. Supp. 437, 441 (S.D.N.Y. 1982).

In *Maritan*, the plaintiff had invested in a real estate venture. The parties' contract vested "managerial" responsibility with the defendant, although the plaintiff in fact had input into or approved several transactions. 875 F.2d at 1455-56 (listing examples). Like the Doctors, Maritan sought to argue that his efforts were not "managerial" and hence were not relevant for purposes of applying *Howey*. *Id.* at 1456-57: "[Maritan's] approach to the case focuses mainly on the distribution and exercise of managerial responsibility for this project." *Id.* at 1457. The Tenth Circuit rejected reliance on talismanic terms such as "managerial," and

instead examined the substance of the transaction in light of the *Howey* test:

> Whether or not exercised, Maritan's access to critical information about the venture, his power under the agreement, *and his demonstrated active involvement* gave him sufficient control over the ultimate expectation of profits so that the third prong of the *Howey* test, as defined in this circuit, is inapplicable as a matter of law.

Id. at 1459 (emphasis added).

In *Inforex*, the district court expressly rejected the "managerial efforts" test proferred by the Plaintiff-Doctors and made the basis for the Court of Appeals' decision. In *Inforex*, plaintiff was the assignee of the interest of Sean Connery in residual payments under a contract he entered into as part of his compensation for playing British superspy James Bond in a series of highly successful films. He later claimed that his interest in the films was a "security", arguing that although he made substantial efforts toward the venture's success, "managerial" control was vested in others. The court rejected the distinction:

> Plaintiff, while conceding that the complaint alleges that Sean Connery played the role of James Bond in the particular James Bond films at issue here, nevertheless attempts to distinguish this significant acting effort from the managerial efforts emphasized by *Howey* and its progeny. . . . In this case, alleging that Sean Connery agreed to play and did play James Bond in the relevant films establishes that he had an undeniably significant role in the venture. . . . Plaintiff has set forth no argument, and the court has found none, that would require that the efforts must be "managerial" unless that term is broadly defined to include any active participation directed toward securing the profitability of the venture.

608 F. Supp. at 133.

The decisions of the courts rejecting the "managerial efforts" test comports both with this Court's holding in *Howey* and with

later cases stating that an investor must expect his profits to come from the efforts of others. Courts have held, for example, that an expectation of profits derived from appreciation in property values does not meet this test. *Grenader v. Spitz*, 537 F.2d 612, 619 (2d Cir.), *cert. denied*, 429 U.S. 1009 (1976); *Bender v. Continental Towers Limited Partnership*, 632 F. Supp. 497, 501 (S.D.N.Y. 1986) (no security where investors "were simply drawn in by an expectation of appreciation."). This is because the expectation of profits does not depend upon "the efforts of the promoter or other third party," *id.* at 501, but rather on the impersonal workings of the marketplace for real estate. *Grenader*, 537 F.2d at 619. The efforts of the Plaintiff-Doctors in this case far exceed those of the investors in cases such as *Maritan* and *Inforex*. In each of those cases, the courts held that no security existed as a matter of law. Petitioners respectfully submit that the Court of Appeals' decision conflicts with those holdings.

3. The Court of Appeals' Decision Conflicts with the "Undeniably Significant Efforts" Test Utilized by Other Federal Courts

The test applied by the Court of Appeals represents a fundamental departure from the analysis utilized by other federal courts in applying the third prong of *Howey*.

In reaching its decision, the Court of Appeals noted the trial court's conclusion that the undisputed summary judgment facts showed "that the Plaintiffs were actively involved in the hospital, contributed to its profitability and were crucial to its success." App. at A5; 894 F.2d at 152. The Court of Appeals held that such a showing was not enough, however. Rather, it held that unless Plaintiffs' efforts were "managerial," they were not relevant. *Id.*

The Court of Appeals' holding conflicts with the test applied by virtually every other federal court to examine the third prong of

Howey. On its face, the *Howey* analysis suggests that, where a party claims that an interest is an "investment contract", the plaintiff's expectation of profits must hinge on the efforts of the promoter or some other third party. Thus, where market appreciation is expected to provide the investor's return, no security exists, even if the investor retains no authority at all. *Dumbarton Condominium Ass'n v. 3120 R Street Associates Limited Partnership*, 657 F. Supp. 226 (D.D.C. 1987). As the court pointed out in *Bender*, in the cases finding real estate interests to be a security, "[w]ithout the efforts of the promoters, the investments would be virtually worthless." 632 F. Supp. at 501.

Generally, federal courts applying the third prong of *Howey* have granted summary judgment where the evidence showed that the investors' efforts were more than "menial" or "nominal." The test generally applied is perhaps best stated in *Bailey v. J.W.K. Properties, Inc.*, 703 F. Supp. 478, 480 (W.D. Va. 1989):

> [t]he issue is not whether plaintiffs controlled every detail of the breeding program, but *whether the plaintiffs had a significant degree of control* as opposed to an arrangement "where the investors' duties were nominal and insignificant, their roles were perfunctory or ministerial, or they lacked any real control over the operation of the enterprise."

Id. at 480 (emphasis added) (quoting *Fargo Partners v. Dain Corp.*, 540 F.2d 912, 914-15 (8th Cir. 1976)). This "significant efforts" test has been echoed consistently by federal courts in applying *Howey*. *E.g., Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236, 240 (4th Cir. 1988) ("General partnership interests ordinarily are not considered investment contracts because they grant the partners — the investors — control over *significant decisions* of the enterprise.") (Powell, J.) (emphasis added); *Meyer v. Dans un Jardin, S.A.*, 816 F.2d 533, 535 (10th Cir. 1987) (rejecting franchisee's securities claim because "the typical franchisee [does not] expect to profit from

the investment without regard to the franchisee's own business skills"); *Deutsch Energy Co. v. Mazur*, 813 F.2d 1567, 1570 (9th Cir. 1987) (oil and gas interest not security because purchaser retained "significant managerial powers"); *Goodwin v. Elkins & Co.*, 730 F.2d 99, 103 (3d Cir.) ("An investment contract or interest may still be a security even if the investor is required to perform some duties, *as long as those duties are 'nominal or limited and would have little direct effect upon receipt by the participants of the benefits promised by the promoters'* ") (emphasis added; quoting *Lino v. City Investing Co.*, 487 F.2d 689, 692 (3d Cir. 1973)), *cert. denied*, 469 U.S. 831 (1986); *Villenueve v. Advanced Business Concepts Corp.*, 698 F.2d 1121, 1125 (11th Cir. 1983) (interest not an investment contract where investors were required to "make *substantial efforts* toward the profit") (emphasis added), *aff'd en banc per curiam*, 730 F.2d 212, 215 (6th Cir. 1983) (partnership interest held to be security only where "the functions the 'investor' performs are not significant managerial ones, but mere ministerial ones"); *Gordon v. Terry*, 684 F.2d 736, 741 (11th Cir. 1982) ("[A]rrangements which grant the investors control over the significant decisions of the enterprise are not securities."), *cert. denied*, 429 U.S. 1009 (1976); *Williamson v. Tucker*, 645 F.2d 404, 425 (5th Cir.) (possession by investor of "meaningful powers" precludes finding interests are securities as a matter of law), *cert. denied*, 454 U.S. 897 (1981); *Crowley v. Montgomery Ward & Co.*, 570 F.2d 877, 880-81 (10th Cir. 1978). The facts adduced in this case bring it squarely within the court's analysis in *Crowley*:

> It is undisputed that the franchisees contributed both time and effort to the success of the common enterprise. . . . The contribution of time and effort is only a part of the test. Consideration must be given to control over the factors essential to the success of the enterprise. Affidavits submitted by Plaintiffs contain only conclusory allegations that Montgomery Ward controlled success.

> . . . The conclusory allegations in plaintiffs' affidavits contain no facts showing that the factors controlled by Montgomery Ward are critical to the success of the enterprise. *The undisputed facts are that the franchisees had, and exercised, effective and important control over that success. The economic reality is that the contributions of the franchisees significantly and substantially affect the profits* expected from the enterprise. The agency agreement is not a security. . . .

Id. at 880-81 (emphasis added). In this case, despite undisputed summary judgment evidence showing that the Doctors exercised "effective and important control" over the success of the partnership, the Fifth Circuit found that such control was immaterial because, in the eyes of the court, the Doctors' contributions were not "managerial". That holding is in irreconcilable conflict with *Howey* and its progeny.

CONCLUSION

The decision of the Court of Appeals in this case conflicts directly with that of other federal courts and effectively dispenses with the third and most important prong of the *Howey* test. By adopting a talismanic test for the third prong of *Howey* — whether the efforts were "managerial" or not — the Court of Appeals ignored this Court's long-standing rule that in applying *Howey* the courts are to be guided by the "economic reality" of the transaction. *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967). The Court should grant certiorari in order to insure consistent application of federal securities laws.

Respectfully submitted,

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APPENDIX

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APPENDIX A

No. 89-2236

United States Court of Appeals

FIFTH CIRCUIT.

FEB. 12, 1990

L & B HOSPITAL VENTURES, INC., LEO J. BORRELL, BOBBY R. LOWRANCE, PSYCHIATRIC ASSOCIATES OF HOUSTON, P.A., AND DOUGLAS B. HANSEN,
Plaintiffs-Appellants,

v.

HEALTHCARE INTERNATIONAL, INC., WEST OAKS, INC., HEALTHCARE-BROWN MANAGEMENT CO., THE BROWN SCHOOLS, INC., JAMES L. FARISS, JR., DAVID L. WHELAN AND ELLIOTT H. WEIR, JR.,
Defendants-Appellees.

Appeal from the United States District Court for the Southern District of Texas.

Before DAVIS and SMITH, Circuit Judges, and LITTLE, District Judge.[1]

LITTLE, District Judge:

Believing they were bamboozled by the vendee-defendants, vendor-plaintiffs filed suit asserting, among other causes of action, relief under the Securities Exchange Act of 1934. 15 U.S.C. § 78j. The properties which the plaintiffs owned and sold were limited partnership interests in West Oaks, The Psychiatric Institute of Houston, Ltd. The purchaser was the general partner.

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[1] District Judge of the Western District of Louisiana, sitting by designation.

The defendants presented a very narrow issue in their motion for summary judgment. Stripped to its bare essentials, the motion asserts that there is no securities violation as that which was sold and purchased was not a security. The sellers were so inextricably intertwined in the partnership that they are not afforded the protection of the Securities Act. The trial court determined that there was no genuine issue of material fact and granted the defendants' motion, dismissed the plaintiffs' case with prejudice and dismissed the pendent state law claims without prejudice. Plaintiffs' appealed that decision. We REVERSE.

Four physicians, each having a specialty in psychiatry, recognized a need for an inpatient treatment facility for adolescents and children in the Houston area (Tr. 779). The development of the project was discussed with plaintiffs by defendant James L. Fariss, Jr., an employee of co-defendant Brown Schools, Inc. A limited partnership agreement formed under the laws of Texas was signed in September of 1979; the limited partners were three psychiatrists (Hansen, Borrell and Lowrance) and one medical corporation (Psychiatric Associates of Houston, P.A.) whose members specialized in psychiatry. Each limited partner had a 6¼% interest in the partnership. The general partner was Brown Schools, Inc. which owned the remaining 75% interest. According to the physicians, Brown Schools, Inc. had expertise in hospital construction, management and operation.

The nature of the impasse between the limited partners and the general partner is not material to this discussion. We need only observe that some discontent with the investment was the motivating force for plaintiffs to sell their limited partnership interests to the general partner, one of the defendants. The discontent burgeoned into allegations of fraud and deception when the plaintiffs discovered certain post-sale facts which are the basis of their complaint against the defendants.

The standard of review which we follow is summarized in *Jones* v. *Southern Marine & Aviation Underwriters*, 888 F.2d 358, 360 (5th Cir.1989). The standard of review at the appellate level of a district court's grant or denial of summary judgment remains the same as at the trial court level. *Ayo* v. *Johns-Manville Sales Corp.*, 771 F.2d 902, 904 (5th Cir.1985). For summary judgment to be granted, the pleadings, depositions, answers to interrogatories, and admissions on file, together with any affidavits, must demonstrate that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law. *Id.*; Fed R.Civ.P. 56(c). *See also Celotex Corp.* v. *Catrett*, 477 U.S. 317, 322-24, 106 S.Ct. 2548, 2552-53, 91 L.Ed.2d 265 (1986). Under this standard fact questions are considered with deference to the non-movant. *Reid* v. *State Farm Mut. Auto Ins. Co.*, 784 F.2d 577, 578 (5th Cir.1986). The appellate court decides questions of law, however, just as it decides questions of law outside the summary judgment context: *de novo*. *Walker* v. *Sears, Roebuck & Co.*, 853 F.2d 355, 358 (5th Cir. 1988); *Brooks, Tarlton, Gilbert, Douglas & Kressler* v. *United States Fire Ins. Co.*, 832 F.2d 1358, 1364 (5th Cir.1987).

The oft cited *Celotex*, interpreting Rule 56 of the Federal Rules of Civil Procedure, requires the entry of a summary judgment against the party failing to make a showing sufficient to establish the existence of an element essential to that party's case. *Celotex*, 477 U.S. at 322-24, 106 S.Ct. at 2552-53. In this case, the defendants claim that the plaintiffs do not belong to the class of investors to whom the Securities Act offers protection. There is no disagreement that the Securities Act applies to investment contracts and that, generally, investment contracts include limited partnership interests. *Williamson* v. *Tucker*, 645 F.2d 404, 423-24 (5th Cir.), *cert. denied*, 454 U.S. 897, 102 S.Ct. 396, 7 L.Ed.2d 212 (1981). The Supreme Court crafted a definition of investment contract which forms the starting point for our analysis. In *S.E.C.* v. *W. J. Howey Co.*, 328 U.S. 293, 298-99, 66 S.Ct.

1100, 90 L.Ed. 1244 (1946), an investment contract was defined as "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." More recently, however, the Supreme Court has modified the definition of investment contract. In *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837, 852, 95 S.Ct. 2051, 2060, 44 L.Ed.2d 621, 632 (1975), the Supreme Court defined or restated investment contract as "an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or management efforts of others." This circuit has provided additional guidance in light of *Howey* and *United Housing Foundation* directing the benefits of the statute to investors in entities where the " *'efforts made by those other than the investor are undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise'* " (emphasis supplied). *Williamson*, 645 F.2d at 418 (quoting with approval *Securities and Exchange Commission* v. *Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821, 94 S.Ct. 117, 38 L.Ed.2d 53 (1973)); *see also Long* v. *Shultz Cattle Co.*, 881 F.2d 129, 133 (5th Cir. 1989); *Securities & Exchange Commission* v. *Koskot, Inc.*, 497 F.2d 473, 483 (5th Cir.1974).

In ruling in defendants' favor, the trial court found as undisputed facts that the plaintiffs were actively involved in the hospital, contributed to its profitability and were crucial to its success. But the opinion recognizes that the medical acumen of the physicians was not the sole profit generating power unit. The thing needed a head, an operational manager, hence the general partner. The plaintiff limited partners had professional or clinical control but the defendants had managerial control. The trial court equated the professional medical involvement of the plaintiffs and their rights to perform as medical men with being

"significant" within the *Williamson* case, *Williamson*, 645 F.2d at 422. The trial court concluded that:

> The plaintiffs have failed to "designate specific facts showing that there is a genuine issue for trial" and defendants are entitled to judgment as a matter of law.

(Tr. 10). The *Williamson* case analyzed and classified the purchase of joint venture interests in a real estate holding enterprise in Texas. The plaintiffs claimed their interests were investment contracts and that the Securities Acts of 1933 and 1934 gave them status to file a federal suit. The defendants claim that the meaningful powers possessed by the plaintiffs under the joint venture agreements precluded a finding that the joint venture investments were investment contracts.

In the lengthy and thoughtful opinion authored by Judge King, the following language sheds light on the law:

> So long as the investor retains ultimate control, he has the power over the investment and the access to information about it which is necessary to protect against any unwilling dependence on the manager. It is not enough, therefore, that partners in fact rely on others for the management of their investment; a partnership can be an investment contract only when the partners are so dependent on a particular manager that they cannot replace him or otherwise exercise ultimate control.

Williamson, 645 F.2d at 424. In this area of the law, the key is *managerial efforts*. In that connection the plaintiffs presented deposition evidence that they did not have nor in fact employ managerial capacity but were dependent upon the managerial activities exerted by the general partner. The evidence from the plaintiffs included the following:

> 1. The limited partnership agreement between Brown Schools, Inc. (a subsidiary of defendant Healthcare International, Inc.) as general partner and physician plaintiffs, Douglas B. Hansen, Leo J. Borrell, Bobby R. Lowrance,

Psychiatric Associates of Houston, as limited partners. That agreement sets forth the strictures on the limited partners' powers. That agreement, in part, provides that the limited partners do not have the capacity to participate in the management or control of the partnership nor are they capacitated to transact any business for the partnership. When it comes to management, ultimate and sole control is in the province of the general partner. The agreement also provides that the general partner has the exclusive authority to manage the operation and affairs of the partnership and to make all decisions regarding the business of the partnership, including determination of cash reserves, cash distributions, leasing of property, selling of property or refinancing (Tr. 550).

2. Testimony of Leo J. Borrell that the defendants wanted to make sure that the plaintiffs remained limited partners and would not be involved in day-to-day operations. In fact, according to Borrell, the limited partners were informed by the general partners that the limited partners neither had the right nor the obligation, nor would they be allowed by the general partners, to participate in the hospital's day-to-day operations (Tr. 512).

3. Testimony of Bobby R. Lowrance that, as a limited partner, he exercised no control over managerial decisions, expenses, capital expenditures, debt acquisition or payment, hiring or firing, nor did he have any control over access to the business or financial information concerning the operation of the partnership. The limited partner was dependent upon the managerial and financial expertise of the defendant Healthcare and only provided influence on patient care matters (Tr. 548-49).

4. Testimony of Douglas B. Hansen that the managerial control of the partnership was undertaken by the general partner to the exclusion of the limited partners (Tr. 274-78).

5. The Management Agreement dated 29 September 1979 between the general partner and the manager wherein all the specific operational duties are described (Tr. 588-613).

6. A table of responsibility for hospital admissions for years 1982-1985. That table reveals the percentage of admissions for

which each limited partner (plaintiff, excluding Douglas Hansen) was responsible. The figures could be read to reveal a rather meager contribution of patients to the total pool of admittees (Tr. 32).

7. Testimony of Kay E. Peck, Administrator of the West Oaks Hospital, that she ran the hospital; that she and a vice president for defendant Healthcare handled the operations of the hospital, Healthcare being the general partner, which included contract matters, financial affairs, labor relations and employment fringe benefits. Basically, all administrative duties were handled through her as the designee of the general partner.

In our opinion, there is evidence that plaintiffs never exerted nor had capacity to exert essential managerial efforts. There is evidence that essential managerial efforts of the entity were undertaken in fact and by contract by the defendants. Our findings that the plaintiffs have established specific facts showing a genuine issue for trial should not be interpreted as a finding in favor of the plaintiffs. All that we intended is to demonstrate that upon the documentation presented by the plaintiffs and in the light of existing law, the summary judgment should not have been granted. Accordingly, the judgment is REVERSED and the matter REMANDED.

IN THE

United States District Court

FOR THE
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

L&B HOSPITAL VENTURES, INC., et al.,
Plaintiffs,

vs.

HEALTHCARE INTERNATIONAL, INC. et al.,
Defendants.

CIVIL ACTION NO. H-88-1077

FINAL JUDGMENT

This Court having granted Defendants' motion for summary judgment, this case is hereby DISMISSED with prejudice. The pendant state law claims are dismissed without prejudice.

This is a FINAL JUDGMENT.

Signed this 2nd day of February, 1989 at Houston, Texas.

NORMAN W. BLACK
United States District Judge

IN THE

United States District Court

FOR THE
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

L&B HOSPITAL VENTURES, INC., et al.,
Plaintiffs

vs.

HEALTHCARE INTERNATIONAL, INC. et al.,
Defendants.

CIVIL ACTION NO. H-88-1077

ORDER

Pending before the Court are Defendants' motion for summary judgment, counterclaim and third-party Defendants' motion for summary judgment and Plaintiffs' motion for partial summary judgment. For the reasons set forth below the Court is of the opinion Defendants' motion should be granted and the other motions denied.

In 1976 or 1977 Plaintiffs Borrell, Lowrance and Hansen along with a Dr. McReynolds decided to develop a new psychiatric hospital where they would admit their patients. In June of 1979 Plaintiffs reached an agreement with Brown Schools, Inc. (Brown), now a subsidiary of Defendant Healthcare International, Inc., whereby Plaintiffs would own 25% of the project and Brown 75% pursuant to a limited partnership agreement. Brown was to provide administrative services and arrange for financing the construction of the hospital. The Psychiatric Institute of Houston, a limited partnership, was formed in September of 1979.

This suit arises out of the Defendants' purchase of Plaintiffs' limited partnership interests in the hospital. Plaintiffs have alleged statutory and common law fraud, breach of fiduciary duty, breach of contract and deceptive trade practices. Federal jurisdiction is based on violations of the Securities Exchange Act of 1934.

To assert securities fraud a Plaintiff must plead and establish fraud in connection with the purchase or sale of a security. Defendants contend in their motion for summary judgment that this case should be dismissed because the limited partnership interests at issue are not securities as defined in the federal securities laws. The sole issue to the decided by the court at this time is whether Plaintiffs' limited partnership interest was an investment contract thus making it a security.

The Securities and Exchange Act, § 3(a)(10), 15 U.S.C. § 78c(a)(10) lists numerous instruments considered to be securities. The term securities has been interpreted broadly and the investment contract has been used to bring "instruments of 'more variable character' within the scope of the federal securities laws." *Landreth Timber Co.* v. *Landreth*, 471 U.S. 681, 686 (1985) (citations omitted). "'[I]nvestment contracts,' *may* encompass limited partnership interests." *Frazier* v. *Manson*, 651 F.2d 1078, 1080 (5th cir. 1981) (emphasis added). However, the "Supreme Court has repeatedly emphasized that economic reality is to govern over form and the definitions of the various types of securities should not hinge on exact and literal tests. *Williamson* v. *Tucker*, 645 F.2d 404, 418 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981).

The test for what constitutes an investment contract is found in *S.E.C.* v. *W. J. Howey Co.*, 328 U.S. 293 (1946) which holds that an investment contract is "a contract, transaction or scheme whereby a person invests his money in common enterprise and is led to expect profits solely from the efforts of the promoter or a

third party." *Id.* at 298-99. For the purposes of this case it is only necessary to focus on one element of the *Howey* test: did the Plaintiffs expect profits solely from the efforts of others?

Since *Howey*, the Fifth Circuit has concluded that a literal application of the word "solely" is unwarranted and it should be interpreted in a more flexible manner. *SEC* v. *Koscot Interplanetary, Inc.*, 497 F.2d 473, 480 (5th Cir. 1974). Presently, the appropriate inquiry is whether "the efforts made by those other than the investor are undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." *Williamson*, 645 F.2d at 418.

Federal securities laws "were not intended to provide a federal remedy for all fraud or misconduct arising out of commercial transactions" *Youmans* v. *Simon*, 791 F.2d 341, 346 (5th Cir. 1986) *citing Marine Bank* v. *Weaver*, 455 U.S. 551, 556 (1982). "Agreements negotiated one-on-one creating enterprises in which investors are actively involved, knowledgable, and able to protect their interests are not within the ambit of the federal securities laws. *Id.* As a result an "investor who has the ability to control the profitability of his investment, . . . is not dependent upon the managerial skills of others. Thus . . . arrangements which grant the investors control over the significant decisions of the enterprise are not securities." *Gordon* v. *Terry*, 684 F.2d 736, 741 (5th Cir. 1982), *cert. denied*, 459 U.S. 1203 (1983). In addition, when an investor has partial control of an enterprise he does not always need the extensive protection of the federal securities laws. *Fraizer* v. *Manson*, 651 F.2d 1078, 1088 (5th Cir. Unit A 1981). The key issue is whether the managerial efforts are functionally essential or undeniably significant to make a profit. *Cameron* v. *Outdoor Resorts of America, Inc.*, 608 F.2d 187, 193 (5th Cir. 1979), *modified on rehearing on other grounds*, 611 F.2d 105 (1980).

Summary judgment is authorized if there is no genuine issue as to any material fact and the moving party is entitled to judgment as a matter of law.. Rule 56, Fed. R. Civ. P. The United States Supreme Court has interpreted this rule to mandate the entry of summary judgment after an adequate time for discovery against a party who fails to make a showing sufficient to establish the existence of an element essential to that party's case, and on which that party will bear the burden of proof at trial. *Celotex Corp.* v. *Catrett*, 477 U.S. 317 (1986).

In reviewing a motion for summary judgment, this Court must determine whether the undisputed facts, considered in the light most favorable to the party opposing the motion, establish that the moving party is entitled to judgment as a matter of law. *Adickes* v. *S. H. Kress & Co.*, 398 U.S. 144 (1970). Although Plaintiffs believe otherwise, summary judgment is "not a disfavored procedural shortcut, . . . [and] designed 'to secure the just, speedy an inexpensive determination of any action'." *Celotex* at 2555 (quoting Rule 1, Fed. R. Civ. P.). It is mandatory that a Court grant a well-supported motion when the nonmovant does not adequately defend against it. *Mosby* v. *American Medical International, Inc.*, 656 F.Supp. 601, 605 (S.D. Tex. 1987).

Defendants have the burden of demonstrating there is no actual dispute as to any material fact. Here they must show that the limited partnership truly operated like a general partnership in that the limited partners actually participated in the management and control of the hospital. Once this has been done the Plaintiffs must do more than simply allege a fact issue exists. They must set forth *specific facts* showing that there is a genuine issue for trial. Rule 56(e), Fed. R. Civ. P. (emphasis added). This they have failed to do.

Contrary to Plaintiffs' argument, the Court finds that the Plaintiffs have failed to meet the requirements of *Howey* and show the limited partnership interests at issue were securities.

First of all the Plaintiffs place much weight on the fact that the parties had entered into a Limited Partnership Agreement and a Management Agreement with the Defendant. However, when one is evaluating whether something is a security "form should be disregarded for substance and the emphasis should be on economic reality." *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837, 852 (1975). The Fifth Circiut has held that Courts must look beyond mere labels when defining a security. *Darly* v. *Morgan*, 701 F.2d 496, 499 (5th Cir. 1983).

Generally, limited partners play a passive rather than active role in their investment. Here, it is undisputed the Plaintiffs were actively involved in the hospital, contributed to its profitability and were crucial to its success. The Plaintiffs agree that a hospital is doctor driven and if doctors fail to admit patients a hospital will fail.

The pleadings and affidavits filed in this case show that the Plaintiffs were the ones who decided to build a hospital for their patients and promoted it to various investors. Borrell at 14-19, Lowrance at 48-52. The physicians wanted and needed a partner that could handle the hospital's business operations and the Defendants were to provide operational management and capital. Hansen p. 70, Lowrance p. 51-52. In addition, the limited partnership agreement gave the general partner the sole discretion to lease, sell, or refinance the property and to determine how much partnership cash to hold in reserve and how much to distribute. Plaintiffs argue that because the doctors were not involved in this type of operations their limited partnership interest was a security. The problem with this argument is that the management of this enterprise consisted of two separate components and the doctors admit they had "clinical" control over the hospital and actively participated in staff education, program design and development, personnel evaluations, the physical structural design and equipment purchases.

Plaintiff Hansen served as Medical Director. The Medical Director is responsible for overseeing the medical and clinical aspects of the hospital which includes advising the administrator on policies, administrative and employee problems and developing organizational plans. The Plaintiffs also served as Unit Medical Directors. Persons in these positions review and approve all clinical business of the hospital.

In addition, the limited partners provided services pursuant to a "Clinical Advisory Agreement" which had the power to approve all new clinical and therapy programs, hire and fire the medical director and control who practiced at the hospital. Plaintiffs also provided services under the Children's Programs Clinical Agreement. Finally, the limited partners served on the Hospital Credentials Committee and Continuing Education Committee.

According to the deposition of Dr. McReynolds, 75-90% of the initial revenue was derived from the limited partners' patients. In addition he admitted that while he was a partner 50-65% of all patients admitted were provided by the Plaintiffs. Significant contributions by the doctors to the hospital's success are also presented in the depositions of Plaintiffs Borrell and Lowrance. Borrell at 52, 62-66, 192-93, 215. Lowrance at 72-81.

The Fifth Circuit has made it clear that if an investor's rights are "significant," the interest is not a security. *Williamson* 645 F.2d at 422. "Limited partnership interests are generally held to be securities interests because the limited partners have no voice in management decisions." *Gordon* v. *Terry*, 684 F.2d 736, 741 n.5 (11th Cir. 1982). However the cases clearly show that the focus should be on what degree of influence and control the limited partners possessed rather than on what functions they did not control.

Based on the above, the Court finds the Plaintiffs played a significant role in the overall success or failure of the venture. The Plaintiffs have failed to "designate 'specific facts showing

that there is a genuine issue for trial.'" and Defendants are entitled to judgment as a matter of law. *Celotex supra.* The record shows this is simply a state law partnership dispute.

As to the pendant state claims, this Court chooses to exercise its discretion not to hear these claims since the sole federal claim is being dismissed. *United Mine Workers* v. *Gibbs,* 383 U.S. 715, 726 (1966). This dispute belongs in the state court system. As a result the Plaintiff's partial motion for summary judgment as to liability and counterclaim and third party's motion for summary judgment are denied without prejudice. Accordingly, it is

ORDERED that Defendants' motion for summary judgment is GRANTED. It is further

ORDERED that Plaintiffs' partial summary judgment as to liability is DENIED. It is further

ORDERED that countclaim and third-party Defendants' motion for summary judgment is DENIED.

Signed this 2nd day of February, 1989 at Houston, Texas.

NORMAN W. BLACK

Norman W. Black
United States District Judge

No. 89-1832 (2)

Supreme Court, U.S.
FILED
JUN 15 1990
JOSEPH F. SPANIOL, JR.
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

HEALTHCARE INTERNATIONAL, INC.,
WEST OAKS, INC., HEALTHCARE-BROWN MANAGEMENT CO.,
THE BROWN SCHOOLS, INC., JAMES L. FARISS, JR.,
DAVID L. WHELAN, AND ELLIOTT H. WEIR, JR.
Petitioners,

v.

L&B HOSPITAL VENTURES, INC.,
LEO J. BORRELL, BOBBY R. LOWRANCE,
PSYCHIATRIC ASSOCIATES OF HOUSTON, P.A.,
AND DOUGLAS B. HANSEN,
Respondents.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

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RESPONDENTS' BRIEF IN OPPOSITION

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QUESTION PRESENTED

This is a federal securities fraud action brought by the former limited partners of a *bona fide* limited partnership. The district court granted summary judgment and dismissed the lawsuit for lack of subject-matter jurisdiction on the sole ground that plaintiffs' limited partnership interests did not constitute "investment contracts." The court of appeals reversed and remanded, finding that plaintiffs had established specific facts showing a genuine issue for trial. The question presented is whether the court of appeals correctly held that summary judgment should not have been granted against plaintiffs in light of the abundant record evidence showing that defendants controlled the limited partnership and that defendants exploited this control to deny plaintiffs access to material information about the limited partnership.

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STATEMENT OF THE CASE

This lawsuit arises out of defendants' purchase of plaintiffs' 25% ownership interest in West Oaks, The Psychiatric Institute of Houston, Ltd., a Texas limited partnership that owned West Oaks Hospital, a psychiatric facility located in Houston, Texas.[1] Plaintiffs, L&B Hospital Ventures, Inc., Leo J. Borrell, Bobby R. Lowrance, Psychiatric Associates of Houston, P.A., and Douglas B. Hansen, are all doctors (or entities whose principals are doctors) who are former limited partners. Defendants, who collectively manage the business and operations of the hospital, are the general partner (West Oaks, Inc.), its parent company (Healthcare), its affiliates (Brown Schools, Inc. and Healthcare - Brown Management Co.) and its officers (James L. Fariss, Jr., David L. Whelan and Elliott H. Weir, Jr.).

A. The Limited Partnership Agreement And The Management Agreement Gave Defendants Total Managerial Control Over West Oaks Hospital

Douglas B. Hansen, the chief of the child psychiatry department at Baylor University, and three other faculty members, Leo J. Borrell, Bobby R. Lowrance and Edward U. McReynolds (a principal of Psychiatric Associates of Houston, P.A.), saw a need in the mid-1970's for an inpatient treatment facility for children and adolescents in the Houston, Texas area. R. 779, 830-32. The doctors, who knew that they "couldn't do the business parts of it," searched for a partner that could develop the project. R. 717.

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[1] To promote clarity, petitioners shall be referred to herein as "defendants" and respondents as "plaintiffs" or "the limited partners" or "the doctors."

The doctors wanted and needed an experienced partner that could design the hospital, provide for financing, oversee the construction, and administer and manage the hospital and its operations after it was built. R. 717-18, 780-81, 833-34. Defendant James L. Farris, Jr., on behalf of defendant Brown Schools, Inc., approached the doctors about developing the proposed hospital project. R. 779-82. The ensuing discussions led to the formation of a limited partnership. *Id.*

The West Oaks Limited Partnership Agreement was executed on September 29, 1979, by Brown Schools, Inc. and Drs. Lowrance, Borrell and Hansen and Psychiatric Associates of Houston, P.A. R. 869. The general partner, Brown Schools, Inc., owned a 75% interest and managed and controlled the partnership. R. 873. Defendants granted plaintiffs an aggregate 25% ownership interest as limited partners. *Id.*[2]

The Limited Partnership Agreement stated that the limited partnership was being formed pursuant to the Texas Uniform Limited Partnership Act and that the rights and liabilities of the parties would be as provided by that statute. R. 869. Accordingly, the limited partners' liability for any partnership debts was limited to the amount of the limited partners' initial capital contributions. R. 877-78. The limited partners could not dissolve the partnership. R. 896. Most importantly, the agreement prohibited the limited part-

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[2] The limited partnership was originally called Psychiatric Institute of Houston, Ltd. and the general partner was Brown Schools, Inc. The Limited Partnership Agreement was later amended to substitute defendant West Oaks, Inc. as general partner and the partnership's name was changed to West Oaks, the Psychiatric Institute of Houston, Ltd.

ners from exercising any management powers. It expressly stated that "[t]he Limited Partners shall not participate in the management or control of the Partnership's business nor shall they transact any business for the Partnership, nor shall they have the power to act for or bind the Partnership, said powers being vested solely and exclusively in the General Partner." R. 877.

The Limited Partnership Agreement provided that the general partner "shall have exclusive authority to manage the operations and affairs of the Partnership and to make all decisions regarding the business of the Partnership." R. 878. It granted the general partner "the right, power and authority to do on behalf of the Partnership all things which, in the General Partner's sole judgment, are necessary, proper or desirable to carry out the aforementioned duties and responsibilities." *Id.* Two such powers are especially relevant to this lawsuit. First, the general partner retained the sole discretion to determine how much partnership cash to budget for reserves and how much to distribute to the limited partners as profits. R. 872-73. Second, the general partner possessed the sole discretion to lease, sell or refinance any partnership property. R. 878-79.

On September 29, 1979 (the same date as the Limited Partnership Agreement), Brown Schools, Inc., as general partner, signed a Management Agreement with Brown Schools, Inc., as manager. R. 588. The Management Agreement provided that Brown Schools, Inc., through a Hospital Administrator, shall "manage all aspects of the operation of the Hospital, including but not limited to staffing, accounting, billing, collections, setting of rates and charges and general admin-

istration." R. 590. In addition, it authorized Brown Schools, Inc. to prepare, for each fiscal year, a capital expenditures budget, an operating budget, and a projection of cash receipts and disbursements. R. 595-96.

In September 1981, two full years after the signing of the Limited Partnership Agreement and the Management Agreement, West Oaks Hospital opened and began admitting patients. Defendant Healthcare International, Inc. ("Healthcare") employed Kay E. Peck to act as Hospital Administrator.[3] Ms. Peck testified unequivocally that, as Hospital Administrator, "I ran the hospital." R. 106. She reported to Jean Smith, Healthcare's Vice President for Psychiatric Operations. R. 93. Together, they determined "the operations of the hospital, contracts, financial status, budgets, staffing" and all other important matters. R. 94-95.

Healthcare itself exercised direct control over many crucial aspects of the hospital's operations. Ms. Peck testified, for example, that "the corporate office" controlled the hospital's capital expenditures, debt incurrence, and the amount and frequency of the limited partners' profit distributions. R. 106. Healthcare's control over the hospital's operations was so tight that any expenditure over $500 required its prior approval. R. 103-04. In addition, Healthcare took direct responsibility for handling the hospital's insurance coverage and labor union matters, and for purchasing the hospital's supplies, drugs, equipment, furnishings, materials and services. R. 97, 99.

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[3] Healthcare is the parent company of all the defendant corporations. The individual defendants, James L. Fariss, Jr., David L. Whelan and Elliott H. Weir, Jr., serve as the top officers and directors for all the defendant corporations.

Defendants made certain that, in accordance with the Limited Partnership Agreement, the limited partners did not participate in the hospital's management. As Dr. Borrell testified, defendants "want[ed] to make sure that we remained limited partners and not involved in the day-to-day operations." R. 508. He specifically recalled that defendants "told us as limited partners we did not have a right or obligation nor would they allow us to participate in day-to-day operations." R. 512-13.

Dr. Lowrance confirmed that the limited partners had no control over the managerial decisions of the partnership; no control over the expenses incurred by the limited partnership; no control over the capital expenditures made by the partnership; and no authority to incur any debt on behalf of the partnership. R. 548-49. He testified further that the limited partners depended on defendants' managerial and financial expertise to operate the partnership. R. 549.

Dr. Hansen corroborated these facts. R. 523-526. He confirmed that Healthcare determined the amount and frequency of partnership cash distributions, R. 525, and the amount the hospital charged patients for the medical services rendered by the limited partners. R. 526.

B. Defendants Controlled West Oaks Hospital's Clinical Affairs

The limited partners, as doctors, treated patients at West Oaks Hospital and served on the Hospital Credentials Committee and the Continuing Education Committee. But the hospital's clinical business, like all its business, was controlled by defendants. The general partner, West Oaks, Inc., adopted a resolution

on August 19, 1981 (just weeks before West Oaks Hospital opened), creating a Governing Body known as the Board of Directors and appointing defendants' own officers and employees as the sole voting members. R. 488. The Board of Directors controlled "all aspects of the medical and administrative management of the Hospital." R. 491. It was "the final authority in all Hospital and Medical Staff matters" and could "overturn any decision of the Medical Staff." R. 490. Kay Peck, the Hospital Administrator and a full-fledged member of the Board, confirmed that it was the Board's responsibility to "[s]et policy and review the operations of the hospital" and "approve the actions of the medical staff." R. 48.[4]

Defendants signed on December 12, 1979, a Clinical Advisory Agreement with a professional corporation operated by Drs. Lowrance and Borrell. R. 907. It gave defendants the right to "institute, terminate or change in any material respect any Hospital clinical program" by giving the doctors prior notice. R. 909. Drs. Lowrance and Borrell, in contrast, could only "recommend" and "consult" with defendants about "clinical issues" and "clinical programs." R. 908. Defendants unilaterally terminated the Clinical Advisory Agreement effective December 12, 1985. R. 615.

Defendants also signed on December 12, 1979, a Children's Programs Clinical Agreement with a

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[4] Two plaintiffs, Drs. Lowrance and Hansen, as well as Dr. McReynolds, held ex-officio positions at various times on the Board. Oddly, the Hospital Administrator could not "remember" at deposition whether these doctors had a vote. R. 48-49. As non-voting members, plaintiffs' positions on the Board gave them no control over the hospital's clinical affairs.

professional association operated by Dr. Hansen. R. 917. It provided that Dr. Hansen shall perform the "clinical services" necessary to operate the children's program at the hospital. R. 918. Like the Clinical Advisory Agreement, defendants expressly reserved the right "to discontinue or change" the children's program. R. 919.

Defendants entered into another agreement with Dr. Hansen, effective June 1, 1985 (nearly four years after West Oaks Hospital opened), whereby he served as the hospital's Medical Director. R. 949. The agreement provided that Dr. Hansen "shall report to and be under the direction of the administrator of Hospital." R. 951. The other limited partners held subordinate Unit Medical Director positions on comparable terms.

The Medical Director position was subject to the Clinical Advisory Agreement, which gave defendants the right to "terminate or change in any material respect the authority or duties of the Medical Director" on prior notice. R. 909. In addition, the Clinical Advisory Agreement gave defendants the right to terminate the Medical Director on prior notice. R. 908. It also provided that the hospital shall not hire any Medical Director not approved by the doctors and shall terminate any Medical Director on prior notice from them. *Id.* This power was limited by another agreement between the parties which provided that the doctors shall have the right to review and approve the hiring of the Medical Director only "[s]o long as such actions do not adversely affect Doctors' status as limited partners." R. 823.

Kay Peck, the Hospital Administrator, acknowledged that the limited partners lacked "clinical con-

trol." R. 105. She recalled that the limited partners often told defendants that they "wanted to be on the management committee and the Board and the long-range planning committee of the hospital and HII [Healthcare]. And they wanted to be in charge of professional staff relationships and they wanted to supervise all AHP's [Allied Health Professionals], nurses, and admitting staff." R. 102. Defendants refused the limited partners' demands, including voting membership on the Board of Directors which controlled all medical and staff matters, because "[t]hat was not a good idea." *Id.* Ms. Peck admitted that she "couldn't permit that as administrator." R. 105.

C. Defendants' Own Records Show That The Limited Partners Admitted A Small And Steadily Decreasing Percentage Of Patients To West Oaks Hospital

Plaintiffs contributed to West Oaks Hospital's success "[b]y working hard as doctors and doing good patient care," and by advising the hospital on its clinical programs and related matters. R. 791. In addition, plaintiffs contributed to the hospital's revenues to the extent they admitted patients there for treatment.

The doctors speculated at deposition about the percentage of the hospital's revenues they generated through patient admissions. R. 789-90, 931. That testimony was uninformed (and erroneous) guesswork, however, inasmuch as the hospital management had always withheld this information from the limited partners. Dr. Borrell made this clear when defendants' counsel interrogated him:

Q: Are the percentages that you have given me, the 30 to 50 percent, is that what you believed were your contribution to the revenues?

A: No. That's what I'm saying. . . . We were asking for that information and the hospital would not give us that information. . . . And they took the position that was really not information that limited partners had privy to.

Q: Did they say why you weren't, as limited partners, entitled to that information?

A: They said that was the operations of the hospital. Because we were limited partners, we didn't have any rights to have information which they decided we shouldn't have regarding the operations. . . . R. 509-11.

In contrast, defendants themselves compiled West Oaks Hospital's admissions statistics in February 1986 (a few weeks before defendants purchased plaintiffs' limited partnership interests). R. 58&60, R. 642-44. Those statistics, taken from the hospital's own records, show the exact percentage of admissions attributable to the doctors during the four full years that they held limited partnership interests:

	1982	1983	1984	1985
Hansen	0%	0%	0%	0%
Borrell	12%	7%	8%	3%
Lowrance	8%	5%	4%	1%
Parikh	8%	7%	6%	3%
Boylston	4%	[illegible]%	.50%	1%
Olsson	0%	0%	0%	.60%
Bohnn	1%	.33%	.25%	0%

These figures show that the percentage of patient admissions attributable to the limited partners was small at the start, became smaller, and eventually became negligible. In sum, the doctors made a small and steadily decreasing contribution to the hospital's success.

D. Defendants' Total Control Over The West Oaks Limited Partnership Enabled Them To Defraud The Limited Partners By Denying Them Access To Material Information About The Hospital

Defendants' control over West Oaks Hospital grew increasingly hostile throughout 1985. Defendants advised Drs. Lowrance and Borrell on September 12, 1985, that the hospital was exercising its right to unilaterally terminate the Clinical Advisory Agreement. R. 615. In addition, the limited partners had longstanding concerns about the way the general partner was managing the hospital's finances. Defendants refused the limited partners' repeated requests to distribute more profits or to refinance the hospital to make more cash available. R. 532-34, 536-40.

The parties held meetings throughout January-March, 1986, to discuss these problems. The outcome was that defendants offered to purchase the doctors' limited partnership interests. Defendants, who controlled the management and operations of the hospital at all times, provided the limited partners with virtually no financial information at these meetings. R. 229.

The terms and conditions of the purchase transaction are set forth in the counterpart Agreements For Sale And Assignment Of Limited Partnership In-

terest In West Oaks, The Psychiatric Institute of Houston, Ltd., each dated March 21, 1986. R. 137. The parties to the Agreements For Sale are the limited partners and the self-styled "Healthcare Group": defendants Healthcare, Healthcare-Brown Management Company, and West Oaks, Inc. The sale agreements provided that defendants shall pay a total of $12 million for the limited partners' aggregate 25% ownership interest in West Oaks Hospital.

The $12 million purchase price for the limited partners' 25% interest indicates a $48 million overall value for the hospital. The doctors did not, and could not, know whether $12 million was a fair price, however, because, as limited partners excluded from the hospital's management and denied access to essential information, they did not know the hospital's value. Therefore, the limited partners insisted that defendants include the following representation and warranty in the sale agreements:

> *Disclosure.* The Healthcare Group has disclosed to [the limited partners] all material information regarding the Partnership, its operations and [the limited partners'] Ownership Interest." R. 150.

The sale agreements expressly stated that the limited partners are "relying" on this particular representation and warranty being "true and correct." R. 158. At the closing on March 28, 1986, defendants certified that the representation and warranty of full disclosure that the Healthcare Group had made in the sale agreements remained true as of that date. R. 169.

In fact, as the limited partners later learned, defendants' representation and warranty was false

when it was made (as was the certification). The record shows that, in November 1985, defendants began secretly considering the formation of a real estate investment trust ("REIT") called HealthVest, a financing vehicle which involved the sale-and-leaseback of several Healthcare facilities, including West Oaks Hospital. R. 171. Defendants had already commissioned an appraisal by Valuation Counselors, the nation's leading hospital valuation firm, that showed, as of October 31, 1985, that West Oaks Hospital had an $88,207,000 business enterprise value. R. 172, 177. The Valuation Counselors' report defined "business enterprise value" as "what a prudent investor would be willing to pay for ownership of [the] business enterprise." R. 176.

The record further reveals that, on March 3, 1986 (three weeks before the parties closed the Agreements For Sale), defendants submitted to Smith Barney, Harris Upham & Company, the REIT underwriter, a five-year forecast for West Oaks Hospital's operations which projected steadily increasing revenues and earnings. R. 179. Defendants provided these same financial projections to Valuation Counselors, which used them to prepare an updated appraisal that showed, as of March 14, 1986 (two weeks before the parties closed the Agreements For Sale), that West Oaks Hospital had an $84 million business enterprise value. R. 189, 191. Ray Moore, Valuation Counselors' executive vice-president, testified that Valuation Counselors could not have made an accurate appraisal of West Oaks Hospital's value without the financial projections defendants had provided him, but had concealed from the limited partners during the negotiations. R. 248-49.

It is undisputed that defendants did not disclose the REIT, the financial projections or the two appraisals to the limited partners prior to the March 28, 1986, closing of the sale agreements. R. 223, 225, 253-55, 259-61, 266. Accordingly, plaintiffs did not suspect they had been cheated until defendants later issued a prospectus in connection with HealthVest's initial public offering. The prospectus, which defendants filed with the Securities Exchange Commission on May 29, 1986, expressly incorporated the March 14, 1986, appraisal by Valuation Counselors that valued West Oaks Hospital at $84 million. R. 205-07. Plaintiffs thereafter commenced this action.

SUMMARY OF ARGUMENT

The federal securities laws are meant to protect investors who cannot protect their own interests in a venture because they are excluded from its management. The courts presume that limited partners are protected by the federal securities laws because limited partners generally lack management power and control.

Here, the district court granted defendants' motion for summary judgment and dismissed the case for lack of subject-matter jurisdiction on the sole ground that plaintiffs' West Oaks limited partnership interests did not constitute "investment contracts." On appeal, the Fifth Circuit reversed and remanded, finding that "the plaintiffs have established specific facts showing a genuine issue for trial." App. at A7. Defendants' petition for a rehearing *en banc* was denied.

This case warrants no further review. First, it was correctly decided. The district court plainly erred in

disregarding the abundant record evidence showing that defendants alone managed and controlled the limited partnership. Second, the test applied by the court of appeals—a gloss on the *Howey* test—does not pose a conflict among the federal courts. Indeed, the court of appeals has applied the same test for the past fifteen years and this Court has never taken exception. Third, this case turns solely on its facts. The court of appeals specifically identified seven triable issues raised by plaintiffs' evidence. App. at A5-A7.

ARGUMENT

I. The Court of Appeals' Decision Does Not Conflict With This Court's Prior Decisions

Defendants assert that the court of appeals' decision conflicts with this Court's prior decisions. This contention is without merit.

A. The "Managerial Efforts" Test Applied By The Court Of Appeals Does Not Conflict With Any Of This Court's Prior Decisions

The Securities Exchange Act of 1934, 15 U.S.C. § 78 c(a)(10), defines the term "security" to include investment contracts. This Court, in *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298 (1946), stated that an investment contract was "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter or a third party."

All the courts of appeal agree that, in light of the remedial nature of the federal securities laws and the statutory policy of affording broad protection to the public, the word "solely" in the *Howey* test should not be read as a strict or literal limitation. *See, e.g.*,

Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc., 840 F.2d 236, 240 n.4 (4th Cir. 1988) (collecting cases). The Fifth Circuit, in particular, has long interpreted the *Howey* test to mean that an investment contract exists where "the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." *See SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 483 (5th Cir. 1974); *accord, SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

The "management efforts" test, which the court of appeals applied in this case, does not conflict with *Howey*. To the contrary, as this Court recognized in *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 852 (1975), the touchstone of the *Howey* test is "an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others." In short, the court of appeals' test is nothing more than a gloss on the basic *Howey* test.

Defendants' focus is not really on the test applied in this case, but rather the test *as* applied in this case. Defendants assert there was "overwhelming and undisputed evidence" that plaintiffs had substantial control over the hospital's operations and made substantial contributions to its success. Pet. at 12. The court of appeals, however, concluded otherwise based on its review of the record. It specifically identified *seven* triable issues raised by plaintiffs' evidence showing:

> (1) that the Limited Partnership Agreement gave defendants sole control of the hospital;

(2) that defendants excluded the limited partners from participating in the hospital's day-to-day operations;

(3) that defendants did not give the limited partners any access to business or financial information about the hospital's operations;

(4) that defendants did in fact control the hospital to the exclusion of the limited partners;

(5) that the Management Agreement specified that operational control resided with defendants;

(6) that defendants' own admissions figures reveal that plaintiffs made a meager contribution to the hospital's success; and

(7) that the Hospital Administrator confirmed that defendants alone ran the hospital.

App. at A5-A7. In view of all this evidence showing that defendants alone managed and controlled the partnership's business, the court of appeals correctly concluded that the summary judgment should not have been granted.

B. Defendants Did Not Rebut The Presumption That Plaintiffs' Limited Partnership Interests Are Securities

The fact that West Oaks Hospital operated at all times as a *bona fide* limited partnership is sufficient reason, in itself, to deny defendants' petition. Generally, the courts presume that limited partnership interests are investment contracts. *See, e.g., William-*

son v. Tucker, 645 F.2d 404, 423-24 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981); *SEC v. Murphy*, 626 F.2d 633, 640-41 (9th Cir. 1980); *Hirsch v. Dupont*, 396 F. Supp. 1214, 1227 (S.D.N.Y. 1975), *aff'd*, 553 F.2d 750 (2nd Cir. 1977). Limited partners need the protections of the federal securities laws because they have "little or no authority to take an active part in the management of the partnership." *Youmans v. Simon*, 791 F.2d 341, 346 (5th Cir. 1986); *see also Gordon v. Terry*, 684 F.2d 736, 741 n. 5 (11th Cir. 1982) ("Limited partnership interests are generally held to be securities interests because the limited partners have no voice in management decisions").

Defendants now "suggest"—for the first time in this litigation—that West Oaks Hospital was not a *bona fide* limited partnership. Pet. at 14. This suggestion is without merit. To rebut the presumption that plaintiffs' limited partnership interests are securities, it was necessary for defendants to prove that plaintiffs actively participated in the management and control of West Oaks Hospital. Defendants did not, and could not, meet this burden.[5]

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[5] The courts—including the Fifth Circuit—will uphold a summary judgment dismissing a federal securities law action for lack of subject-matter jurisdiction where the record shows that the limited partnership was a sham or the limited partners controlled the venture's management. *See, e.g.*, Gordon v. Terry, 684 F.2d at 741 n.5; Frazier v. Manson, 484 F.Supp. 449 (N.D.Tex. 1980), aff'd, 651 F.2d 1078 (5th Cir. 1981). But here, defendants never once contended that the West Oaks limited partnership did not operate as a *bona fide* limited partnership, nor that plaintiffs acted as *de facto* general partners, nor that plaintiffs should forfeit the limited liability normally accorded to limited partners.

The question whether a limited partnership interest is an investment contract depends, in the first instance, on an examination of the limited partnership agreement itself. *Youmans v. Simon*, 791 F.2d at 346-47; *Williamson v. Tucker*, 645 F.2d at 424 & n. 14. An examination of the way the West Oaks Limited Partnership Agreement distributed management power and control proves, beyond any doubt, that it was an investment contract.

First, the West Oaks Limited Partnership was formed pursuant to the Texas Uniform Limited Partnership Act. R. 869. Limited partnerships formed in accordance with a state's limited partnership act are considered investment contracts "as a matter of law." *Goodman v. Epstein*, 582 F.2d 388, 397, 406-08 (7th Cir. 1978), *cert. denied*, 440 U.S. 939 (1979). The reason is that the limited partnership statute itself prohibits the limited partners from taking part in the management of the venture. *Hirsch v. DuPont*, 396 F.Supp. 1214, 1227 (S.D.N.Y. 1975), *aff'd.*, 553 F.2d 750 (2d Cir. 1977) (citing parallel New York statute). Defendants here did not argue, and there is no evidence to show, that the West Oaks Limited Partnership violated any aspect of the Texas limited partnership statute.

Second, the West Oaks Limited Partnership Agreement contained all the requirements for a genuine limited partnership. The limited partners' liability for the partnership's debts was limited to the amount of the limited partners' initial capital contributions. R. 877-78. The limited partners could not work a dissolution of the partnership. R. 896. Most importantly, the agreement strictly prohibited the limited partners from exercising any management powers. It expressly

provided that "[t]he Limited Partners shall not participate in the management or control of the Partnership's business, . . . said powers being vested solely and exclusively in the General Partner." R. 877.

Third, the West Oaks Limited Partnership Agreement vested "the exclusive authority to manage the operations and affairs of the Partnership and to make all decisions regarding the business of the Partnership" in the defendant general partner. R. 878.

Fourth, the West Oaks Limited Partnership Agreement gave the general partner the sole discretion to determine how much partnership cash to budget for reserves and how much to distribute to the limited partners as profits. R. 872-73. It also gave the general partner the sole discretion to lease, sell or refinance any partnership property. R. 878-79.

Finally, the Management Agreement provided that defendants shall "manage all aspects of the operation of the Hospital." R. 590. The Hospital Administrator, Kay E. Peck, testified that "I ran the hospital" subject to Healthcare's close supervision. R. 106. The doctors' deposition testimony confirmed that defendants actually did control the hospital. R. 508, 512-13, 523-26, 548-49.

The court of appeals specifically cited this evidence in its decision. App. at A5-A7. Defendants simply ignore it. Since the record shows that West Oaks Hospital operated as a *bona fide* limited partnership, plaintiffs' limited partnership interests should be treated as securities as a matter of law.

C. Defendants, Who Own and Operate Twenty-Three Healthcare Facilities, Were The Promoters of West Oaks Hospital

Defendants describe plaintiffs (Drs. Lowrance, Borrell and Hansen), together with Dr. McReynolds, as the "promoters" of West Oaks Hospital. Pet. at 3-6. They note that, between 1976-1979, the doctors contacted various healthcare management companies, incurred professional fees, and filed a certificate of need in connection with a visionary hospital project.

Promoters, for purposes of the federal securities laws, are those individuals whose efforts result in "the organization of a business" and without whose efforts "the investments would be virtually worthless." *Bender v. Continental Towers Limited Partnership*, 632 F.Supp. 497, 501 (S.D.N.Y. 1986). The record shows that it is defendants, and not plaintiffs, who fit this definition.[6]

Plaintiffs' idea for a psychiatric hospital for children and adolescents remained just that—a "notion"—until defendants approached the doctors and, in September 1979, formed the West Oaks limited partnership. R. 713. Until then, the doctors had not made any progress toward the realization of the hospital project; to the contrary, as defendants note, they faced the loss of $120,000 in sunk costs. All plaintiffs had after spending three years and much money was the same dream they had when they started.

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[6] Defendants never define the term "promoter." Instead, they cite a long passage from Reves v. Ernst & Young, 58 U.S.L.W. 4208 (1990), addressing the question whether a demand note should be treated as a security. Reves has no bearing on this case: indeed, the Court stated there that "the Howey test is irrelevant to the issue before us today." Id. at 4211 n.4.

Even the district court recognized that the doctors "wanted and needed" an experienced partner that could design the hospital, acquire the land, arrange for financing, oversee the construction, and administer and manage the hospital and its operations after it was built. R. 8; *see also* R. 717-18, 833-34, 780-81. It was defendants who provided all those essential services with respect to West Oaks Hospital and made it a viable enterprise. Indeed, the June 19, 1979, letter of intent between plaintiffs and defendants specifically stated that "Brown will be responsible for arranging financing, developing and operating the Hospital." R. 823.

Defendants are a large and aggressive healthcare enterprise which owns and operates 23 facilities across the country. R. 263-64. As general partner, defendants did what the doctors could not do—organize West Oaks Hospital. It was defendants who promoted West Oaks Hospital to the limited partners.

D. The Court Of Appeals' Decision Is Not Contrary To This Court's Established Summary Judgment Principles

Defendants assert that the court of appeals' decision is contrary to the summary judgment principles set forth in *Celotex Corp. v. Catrett*, 477 U.S. 317 (1986), because plaintiffs allegedly failed to come forward with any probative evidence on the investment contract issue. This contention utterly ignores the record.

The court of appeals expressly recognized that this case was governed by *Celotex*. App. at A3. Applying the *Celotex* standard, the court of appeals specifically identified seven triable issues of fact raised by

plaintiffs' evidence. *Id.* at A5-A7. In view of this evidence, the court of appeals correctly concluded that the summary judgment should not have been granted.

II. The Court Of Appeals' Decision Does Not Conflict With Other Federal Courts' Holdings

Defendants assert that the court of appeals' decision conflicts with other federal courts' holdings. These alleged conflicts do not exist.

A. Plaintiffs Did Not Possess The Ability To Control The West Oaks Limited Partnership

Defendants rightly commend the court of appeals' decision in *Williamson v. Tucker*, 645 F.2d 404 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981), for its "thoughtful analysis of the application of *Howey* to partnership interests." Pet. at 21-22. They mistakenly assert, however, that the court of appeals' decision in this case conflicts with the principles laid down in *Williamson*.

The court of appeals' decision in this case was plainly guided by *Williamson*. In fact, just like defendants, the court of appeals commended *Williamson* for its "thoughtful" analysis. App. at A5. In particular, it cited *Williamson* for the proposition that the federal securities laws do not protect investors who retain "control"—i.e., "the power over the investment and the access to information about it which is necessary to protect against any unwilling dependence on the manager." *Id.* Applying this standard, the court of appeals then proceeded to identify the specific evidence plaintiffs had presented showing that the limited partners *lacked* this control. *Id.* at A5-A7. Therefore, defendants' assertion that there is "no dispute" that plaintiffs possessed meaningful powers ig-

nores both the court of appeals' opinion and the record. Pet. at 22.

Furthermore, the facts which gave rise to this lawsuit show that defendants used their control over West Oaks Hospital to defraud the limited partners. First, defendants refused the limited partners' repeated requests to distribute more profits or to refinance the hospital. Then defendants terminated the Clinical Advisory Agreement. Faced with these increasingly hostile management actions, the doctors decided to accept defendants' offer to purchase their limited partnership interests. What the doctors did not (and could not) know, however, was that defendants had concealed the following material information during the negotiations: (i) that defendants planned to sell West Oaks Hospital to a real estate investment trust they had secretly formed; (ii) that defendants had prepared a forecast of the hospital's operations which projected steadily increasing revenues and earnings for the 5-year period following the sale of plaintiffs' limited partnership interests; and (iii) that defendants had commissioned two independent appraisals that valued West Oaks Hospital at $84-$88 million, some $40 million more than defendants led the limited partners to believe the hospital was worth.

Plaintiffs had access to none of this information because defendants had excluded them, as limited partners, from the management and control of the hospital. It is precisely these facts, which illustrate defendants' total control over West Oaks Hospital, which reveal the "economic reality" of the West Oaks limited partnership. *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).

B. No Court Of Appeals Has Rejected The Managerial Efforts Test

Defendants assert that other federal courts have rejected the managerial efforts test. Pet. at 23. They rely especially on *Maritan v. Birmingham Properties*, 875 F.2d 1451 (10th Cir. 1989).

The Tenth Circuit did not reject the managerial efforts test in *Maritan*. To the contrary, it reiterated that the managerial efforts test has been the rule in the Tenth Circuit since *Crowley v. Montgomery Ward & Co.*, 570 F.2d 875, 877 (10th Cir. 1975). The court added, however, that the test should be applied mindful that "[t]he principal purpose of the securities act is to protect investors by promoting full disclosure of information necessary to informed investment decisions." 875 F.2d at 1457, *quoting Matek v. Murat*, 862 F.2d 720, 728 (9th Cir. 1988). Therefore, the focus should be on "access to information about the investment" as well as "managerial control." *Id.* The court stated that "the terms of governing agreement" between the parties was a critical factor in making these determinations. *Id.* at 1458; *see Kline Hotel Partners v. Aircoa Equity Interests, Inc.*, 725 F.Supp. 479, 481 (D.Colo. 1989) ("The Tenth Circuit has joined other circuits in focusing on access to information as well as managerial authority").

The court of appeals' analysis in this case comports in every respect with *Maritan's* gloss on the management efforts test. Here, as mentioned earlier, the court of appeals recognized that the key factor in applying the managerial efforts test was whether the limited partners had "the power over the investment and the access to information about it which is necessary to protect against any unwilling dependence

on the manager." App. at A5, *quoting Williamson v. Tucker*, 645 F.2d at 424. Furthermore, the court of appeals paid special attention to the terms of the Limited Partnership Agreement and the Management Agreement, which gave defendants sole control over the partnership and information about the partnership. App. at A5-A7.

Another case defendants rely on heavily is *Inforex Corp., N.V. v. MGM/UA Entertainment Co.*, 608 F.Supp. 129 (C.D. Cal. 1984). There, the district court held that the percentage-of-the-profits clauses in the agreements signed by actor Sean Connery in connection with several James Bond films should not be treated as investment contracts. The district court said that its holding was limited to those particular facts: "The Court is simply stating that performing the role of James Bond in James Bond films is as undeniably significant to the films' success or failure as the production, distribution, or marketing of the films." *Id.* at 133. The district court's broader view—that "any active participation directed toward securing the profitability of the venture" disqualifies an agreement as an investment contract—finds no support in the case law. *Id.* To the contrary, the courts generally agree that investors who contribute to a venture's success may invoke the protections of the federal securities laws so long as they do not control its management. *See SEC v. Koscot Interplanetary, Inc.*, 497 F.2d at 480-83 (collecting and discussing cases); *see also Landreth Timber Co. v. Landreth*, 471 U.S. 681, 693 (1985) ("we cannot agree . . . that the Acts were intended to cover only 'passive investors' "). In short, the *Inforex* decision cannot serve

as the basis for a perceived conflict among the federal courts on this issue.

C. The Court Of Appeals' Decision Does Not Conflict With The Test Applied By Other Federal Courts

Defendants assert that the test generally applied to determine whether an investment contract exists was "best stated" in *Bailey v. J.W.K. Properties, Inc.*, 703 F.Supp. 478, 480 (W.D.Va. 1989). Pet. at 26. Putting aside the question whether *Bailey* deserves the preeminence defendants confer upon it, the fact remains that the district court in *Bailey* and the court of appeals here undertook exactly the same analysis.

The district court in *Bailey* correctly observed that, in determining whether plaintiffs' interests should be treated as investment contracts, "the dispositive issue is what control plaintiffs had and could have exercised." *Id.* at 480. The court stated that it must focus on "the management contract which structured the rights of the parties in this venture." *Id.* The parties' allocation of "the power to make or control significant decisions" was the key factor in determining which party had "the ultimate control." *Id.* at 494, 495.

Once again, the court of appeals in this case undertook exactly the same inquiry. It too stated that the key factor was whether plaintiffs retained "ultimate control"—i.e., "the power over the investment and the access to information about it which is necessary to protect against any unwilling dependence on the managers." App. at A5, *quoting Williamson v. Tucker*, 645 F.2d at 424. In making this determination, the court of appeals focused primarily on the Limited Partnership Agreement and the Manage-

ment Agreement. It observed that these agreements gave defendants the sole control over the partnership and sole control over information about the partnership. *Id.* at A5-A6. It observed further that plaintiffs' deposition testimony confirmed that the hospital was in fact operated in accordance with these agreements. *Id.* Finally, it observed that the Hospital Administrator testified that defendants controlled the hospital. *Id.* at 7. In view of this evidence, the court of appeals correctly concluded that plaintiffs had established specific facts showing a genuine issue for trial. *Id.*

CONCLUSION

The Court should deny the petition for a writ of certiorari. This case should proceed to trial.

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CLERK

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No. 89-1832

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

HEALTHCARE INTERNATIONAL, INC., WEST OAKS, INC., HEALTHCARE-BROWN MANAGEMENT CO., THE BROWN SCHOOLS, INC., JAMES L. FARISS, JR., DAVID L. WHELAN, AND ELLIOTT H. WEIR, JR.,
Petitioners,

v.

L & B HOSPITAL VENTURES, INC., LEO J. BORRELL, BOBBY R. LOWRANCE, PSYCHIATRIC ASSOCIATES OF HOUSTON, P.A., AND DOUGLAS B. HANSEN,
Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

PETITIONERS' REPLY BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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To the Honorable Chief Justice and the Associate Justices of the Supreme Court of the United States of America:

Petitioners Healthcare International, Inc. ("Healthcare"), West Oaks, Inc., Healthcare-Brown Management Co., The Brown Schools, Inc., James L. Fariss, Jr., David L. Whelan, and Elliott H. Weir, Jr., submit this Reply Brief in Support of Petition for Writ of Certiorari:

I. Factual Counter-Statement

In their Brief in Opposition to Healthcare's Petition for Writ of Certiorari, the Respondents have once again shifted their position, denying before this Court factual admissions that they made in the District Court. Federal appeals courts generally should not consider arguments presented for the first time on appeal. *California v. Taylor*, 353 U.S. 553, 556 n.2 (1957).

In this case, the Doctors admitted both in their briefs and to the trial court in oral argument that they made significant contributions to West Oaks' profitability and success. For example, in their brief to the trial court, Plaintiffs admitted contributing 40-60% of the hospital's revenues. R. 471. It was only after the trial court's adverse ruling that they "reinterpreted" the data to suggest to the Court of Appeals that the contributions were not significant.[1]

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[1] The statistics cited in Respondents' Response do not support their conclusions. Respondents have taken a deposition exhibit out of context to suggest that their contributions to revenues were insignificant. Those statistics were part of a report on the Doctors' contributions to West Oaks. The Doctors attached the entire report to their Response to the Motion for Summary Judgment. As the Doctors admitted in their brief in the trial court, "[T]he limited partners accounted for the following percentages of admissions: 1982: 51%; 1983: 41%; 1984: 56%; and 1985: 41%." R. 471. Undoubtedly, this contribution is "significant" by any reasonable definition of that term.

The Doctors also argue in their brief that their access to information regarding the partnership was limited. Brief in Opposition at 11, 26. The Doctors testified in their depositions that under the contracts they had complete access to information regarding the venture. Healthcare International, Inc., et.al.'s Response to Motions for Summary Judgment at 25-26, 37, 44-46.[2] Dr. Hansen testified that he was "inundated" with information regarding the hospital. *Id.* at 45 (citing Deposition of Hansen at 135, 141-45, 164, 184-86, 187-91).

II. Respondents Have Admitted the Conflict Between the Court of Appeals' Opinion and the Prior Decisions of This Court

A. The Court of Appeals' "Gloss" Conflicts with the *Howey* Test

The purpose of the third prong of *Howey* was to exclude from the ambit of securities laws those investors who have, either formally or informally, significant influence over the operation and success of their investment. *Maritan v. Birmingham Properties*, 875 F.2d 1451 (10th Cir. 1989); *Gordon v. Terry*, 684 F.2d 736 (11th Cir. 1982), *cert. denied*, 459 U.S. 1203 (1983). Respondents have conceded that the Court of Appeals applied a "gloss" on the *Howey* test. Brief in Opposition at 14, 15. Petitioners respectfully suggest that the "managerial efforts" limitation fundamentally altered the nature of the *Howey* test. *See Maritan v. Birmingham Properties*, 875 F.2d 1451 (10th Cir. 1989); *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236, 240 (4th Cir. 1988); *Meyer v. Dans un Jardin,*

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[2] The Response of Healthcare to the Doctors' Motions for Summary Judgment was inadvertently omitted from the record sent to the Court of Appeals. Consequently, the Response was not numbered and cannot be cited to the record. It was part of the record before the trial court at the time the court rendered its decision, however. References to the Response shall be cited as "Response at ....."

S.A., 816 F.2d 533 (10th Cir. 1987); *Inforex Corp. v. MGM/UA Entertainment Co.*, 608 F. Supp. 129 (C.D. Cal. 1984).

In applying *Howey*, courts have recognized that where an investor's efforts are menial or ministerial, the investor may nevertheless claim his or her interest is an investment contract, because the investor's efforts have no practical effect upon realization of the anticipated profits. As the SEC has noted:

> [W]here the duties assigned [to the investor] are so narrowly circumscribed as to involve little real choice of action or where the duties assigned would in any event have little direct effect upon the receipt by the participant of the benefits promised by the promoters, a security may be found to exist.

Securities Act Release No. 5211, [1971-1972 Transfer Binder], Fed. Sec. L. Rep. ¶ 98,446 (CCH November 30, 1971); *e.g., SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973). The Doctors have not adduced any evidence that they had no real choice of action, and have admitted that their duties were critical to the profitability of their investment.

In this case the Doctors' efforts were indisputably far more than menial or ministerial. The Doctors testified at length regarding the numerous contributions they made to the hospital and the importance of their participation to the success of the enterprise. *See* Petition for Writ of Certiorari at 5-10. The Court of Appeals brushed those admissions aside, holding that unless those undeniably significant contributions were "managerial," they simply could not be considered in applying the *Howey* test. App. at A5. Petitioners believe that this Court never intended an investor with such a deep involvement in the operations and profitability of his investment to come within the ambit of *Howey*.

B. There Is No Presumption That Limited Partnership Interests Are Securities

Respondents predicate virtually all of their factual statement and much of their Response on the notion that because their interests were formally denominated "limited partnership" interests, they are entitled to invoke the protection of the securities laws. Brief in Opposition at 2-8, 16-19, 26-27. Specifically, Respondents argue that there exists a "presumption" that their interests are securities under the *Howey* test. *Id.* at 16-19.

Respondents' argument is based upon a lone Seventh Circuit opinion holding that limited partnership interests are inherently securities as a matter of law. Brief in Opposition at 18 (citing *Goodman v. Epstein*, 582 F.2d 388 (7th Cir. 1978), *cert. denied*, 440 U.S. 939 (1979)). The Seventh Circuit's opinion in *Goodman* directly conflicts with this Court's requirement that in applying *Howey*, federal courts are to be guided by the economic realities of the parties' relationship rather than by mechanistic reliance on labels. *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967); *Matek v. Murat*, 862 F.2d 720, 727 (9th Cir. 1988). *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975). The conflict between the holdings in *Goodman* and *Matek* simply underscores the need for this Court to grant the petition and reaffirm *Howey's* fundamental requirement that an investor must expect profits to be derived from the efforts of *others* in order to assert his interest in an "investment contract."

The Court has addressed the issue of when a presumption exists that an investment is a security. In *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985), the Court held that only corporate stock was entitled to a presumption of the kind suggested by Respondents. *Id.* at 687-697; *see Reves v. Ernst & Young*, 58 U.S.L.W. 4208 (1990) (holding that notes are not entitled to presumption under Landreth). If instruments expressly listed in the statutes as securities are not "presumed" to be covered by the

act, investments such as the Doctors' limited partnership interests cannot benefit from such a presumption.

In this case, the limited partnership interests at issue were not publicly traded. There were only four limited partners. The agreements reflected the kind of unique one-on-one negotiations that take such interests outside the securities laws. The "economic realities" of the situation overwhelmingly established the substantial control the partner/doctors possessed. In addition to their formal powers under numerous collateral contracts, the Doctors possessed the enormous degree of influence and control possessed by any rainmaker partner in a closely held enterprise. The control and influence exercised in such a situation far exceeds the level of "menial" or "nominal" participation contemplated by *Howey* and later cases.

C. The Doctors, as Promoters of the Venture, Cannot Assert That Their Interests Are Securities

It is both implicit and explicit in *Howey* and its progeny that a promoter is precluded from asserting that his or her interest is a security. In *Howey*, by defining an investment contract as a scheme "whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter or third party," 328 U.S. at 299, the Supreme Court implied that, for the purposes of federal securities statutes, an investor and a promoter are distinct, and that only the former interest constitutes an investment contract.

Cases interpreting the *Howey* decision have made it evident that a "promoter" is to be defined as that party which sought the investment of money by others. Thus, in defining a "common enterprise" under *Howey*, courts frequently refer to schemes wherein the investors' fortunes are dependent on "the efforts and success of those seeking the investment or of third parties," in essence substituting "those seeking the investment" for "promot-

ers" in the language of the *Howey* test. *See, e.g., Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 622 F.2d 216, 223 (6th Cir. 1980); *S.E.C. v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 478 (5th Cir. 1974); *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 n.7 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973). It follows that the "promoter," being the party who induced the investment of another, does not have a "security" as contemplated by the *Howey* test.

In this case, contrary to the Doctors' allegations, the Doctors were in fact the "promoters" of this venture and are precluded from claiming that their interests are securities. It was the Doctors who proposed their scheme to Healthcare and successfully sought "the use of the money of others on the promise of profits." *Howey*, 328 U.S. at 299. The Securities and Exchange Commission, in Rule 405 under the Securities Act of 1933, has defined "promoter" to include:

> (1) Any person who, acting alone or in conjunction with one or more persons, directly or indirectly takes initiative in founding and organizing the business or enterprise of an issuer.

17 C.F.R. 230.405(q). Federal courts have often turned to this common-sense definition to determine if a party is a "promoter" for the purposes of the securities laws. *See, e.g., Townshend v. United States*, 384 F.2d 1008, 1012 (Ct. Cl. 1967); *Ingenito v. Bermec Corp.*, 441 F. Supp. 525, 537 (S.D.N.Y. 1977).

In this case the Doctors exercised the "initiative" in founding and organizing the venture. They undertook efforts to develop a hospital to be owned by them to which they would admit their patients, R. 716-717, 787-788, and for which they would create and implement programs. R. 687-88, 723-26, 779, 831-33. They hired a business consultant and attorneys, filed a certificate of need application for the project, and invested approximately $120,000 in promotional expenses, R. 688, 723-26, 741-76, 784, 813, 832-33, all before they even approached Healthcare in mid-

1979. Furthermore, Healthcare was only one of several companies approached by the Doctors. The agreement ultimately reached created a limited partnership in which Healthcare was to provide administrative services and arrange financing for the hospital. R. 689,779-81, 836, 929-30. Based on these facts, it is evident that the Doctors where the "promoters" of this venture.

III. Respondents Have Ignored the Conflict Between the Circuits Created by the Court of Appeals' Decision

A. The Court of Appeals' Test Has Previously Been Rejected by Other Federal Courts

Contrary to Respondents' assertions, other federal courts have expressly rejected the "managerial efforts" test adopted by the Court of Appeals. A review of the cases cited in the Petition for Writ of Certiorari supports Petitioners' argument.

In *Maritan v. Birmingham Properties*, 875 F.2d 1451 (10th Cir. 1989), the court expressly rejected the "managerial efforts" limitation. In its review of the parties' position, the Tenth Circuit noted that the plaintiff's "approach to the case focuses mainly on the distribution and exercise of *managerial responsibility* for this project." *Id.* at 1457 (emphasis added). The Tenth Circuit rejected this approach: "[T]he language from *Meyer v. Dans un Jardin, S.A.*, 816 F.2d 533, 535 (10th Cir. 1987), upon which Maritan relies is a general, not exclusive, statement." *Id.*

Similarly, in *Inforex Corp. v. MGM/UA Entertainment Co.*, 608 F. Supp. 129 (C.D. Cal. 1984), the court found that the characterization of the efforts as something other than "managerial" did not alter the *Howey* analysis. Respondents ignore the plain language of the *Maritan* and *Inforex* opinions in their

attempt to avoid the clear conflict created by the Court of Appeals' opinion in this case.[3]

B. The Test Applied by the Court of Appeals Conflicts with the Test Applied by Other Federal Courts

In addition to conflicting with every other opinion to directly address the point, the Court of Appeals' opinion implicitly conflicts with the test adopted by other federal courts in applying *Howey*.

In applying *Howey* to partnerships, federal courts generally have been confronted with three distinct factual situations. In many cases, the plaintiff has purchased a general partnership or other interest in an enterprise and retains in the documents formal powers of management and control sufficient to permit him or her to protect his or her interests. In these cases, courts generally have recognized that the failure of plaintiff to exercise those powers does not alter the fact that those powers exist. *E.g., Williamson v. Tucker*, 645 F.2d 404 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981); *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236 (4th Cir. 1988).

Many of the cases Respondents rely upon fall within this category. For example, in *Youmans v. Simon*, 791 F.2d 34 (5th Cir. 1986) (cited at Brief in Opposition at 18) the court held that analysis of the formal documents determined the issue. In *Youmans*, however, the court noted that because plaintiffs were general partners, they had sufficient input into the venture to preclude a finding of a security as a matter of law. 791 at 346. Similarly, in *Williamson*, the Fifth Circuit held that absent

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[3] Similarly, as noted above, there is a conflict between the circuits regarding whether or not an interest denominated a "limited partnership" is inherently a "security" or whether, as Healthcare contends, the courts must apply the *Howey* test to such interests to make sure they fit within the definition of an "investment contract" as that term is used in federal securities laws.

unusual circumstances the formal powers granted a general partner prevent a finding that such an interest is an investment contract. 645 F.2d at 422. In *Kline Hotel Partners v. Aircoa Equity Interests, Inc.*, 725 F. Supp. 479 (D. Colo. 1989), the plaintiffs were general partners. The court found an issue of fact regarding whether unique circumstances precluded them from exercising their management powers. *Id.* at 482. Had the court in *Kline* followed Respondents' urging and looked only at the formal partnership documents, plaintiffs' securities claims would have been precluded as a matter of law. *Id.* at 481-82. Respondents have cited no case in which an investor who in fact had substantial authority over the affairs of the enterprise or who possessed the ability to affect the success and profitability of the venture was found to possess a security based solely on the formal recitations contained in one of the parties' agreements.

A second group of cases are those in which the formal documents between the parties purport to deny authority to the plaintiff, but the plaintiff in reality has significant power and control over the affairs of the enterprise. *E.g., Maritan v. Birmingham Properties*, 875 F.2d 1451 (10th Cir. 1989); *Gordon v. Terry*, 684 F.2d 736 (11th Cir. 1982), *cert denied*, 459 U.S. 1203 (1983); *Frazier v. Manson*, 651 F.2d 1078 (5th Cir. 1981). In such a case, the courts consistently find that no security exists.

Finally, there are cases where both the formal documents and the economic realities deny the plaintiff any significant power to control the operation of the enterprise or to affect its profitability. *E.g., SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946); *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973). In these cases, and only in these cases, do the courts find a security, because only in these cases may it be said in any meaningful sense that the investor expected his profits to be derived solely from the efforts of the promoter at

the time he made his investment. *Rivanna Trawlers Unlimited*, 840 F.2d at 241.

By accepting the Respondents' "managerial efforts" distinction, the Court of Appeals has created an entirely new class of cases, wherein the elements traditionally applied to determine whether an interest is an investment contract are ignored and the label the parties put on their efforts controls.

IV. Conclusion

It is undisputed that Respondents possessed powers of control and influence — both formally by virtue of contractual agreements and informally by virtue of their power to affect profoundly the profitability of the enterprise — that prohibit a finding that their interests were a security. The Fifth Circuit expanded the ambit of federal security laws to situations where they have never heretofore been found to apply. This Court should remove the "gloss" on *Howey* adopted by the Court of Appeals in this case.

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